GSE OVERSIGHT: THE NEED FOR REFORM AND MODERNIZATION

HEARING

BEFORE THE

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CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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GSE OVERSIGHT: THE NEED FOR REFORM AND MODERNIZATION

Wednesday, June 25, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:01 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Shays, Gillmor, Bachus, Castle, Lucas of Oklahoma, Royce, Manzullo, Oxley (ex officio), Kelly, Ney, Fossella, Green, Miller, Hart, Kennedy, Tiberi, Harris, Kanjorski, Hooley, Meeks, Inslee, Moore, Frank (ex officio), Ford, Lucas of Kentucky, Crowley, Clay, McCarthy, Baca, Miller, and Scott. Also present: Representatives Watt and Maloney.

Chairman BAKER. I would like to call this meeting of the Capital Markets Subcommittee to order.

June 15, 2002 was an important day in the history of our national economy. The accounting firm of Arthur Anderson was found guilty of obstructing justice by a Texas jury on that day. The decision ultimately led to the demise of the accounting firm and brought about a thorough reexamination of our entire accounting industry. Frankly, the outcome could have been a lot worse. Our understanding of corporate accounting practices was limited, and action was quickly taken to enhance the regulatory oversight of the industry with the passage of the Sarbanes-Oxley Act.

However, there continue to be important elements of our economy left, inappropriately in my opinion, outside the scope of the Sarbanes-Oxley required disclosures. These are the only two Fortune 500 corporations today exempted from these essential reforms. Why were they exempted? The answer is that they are too well run to worry about. They have set a standard of corporate governance to be emulated by others. And by the way, we want to make sure we don't throw anyone out of the opportunity of homeownership. They are, of course, the two housing GSEs.

The events surrounding the fall of Enron are indeed unfortunate, particularly for the employees, but for anyone who had a financial stake in the corporation. However, if either of the nation's GSEs were to suffer a financial reversal of similar scale, the systemic consequences are difficult to comprehend.

The Capital Markets Subcommittee is meeting today on this very important matter, but frankly as a result of events that are not of our own making. The announcement by Freddie Mac that their recent accounting practices did not properly reflect their operations is cause for significant concern. In fact, the initial restatement announcement was again amended just this morning, raising the total misreported income from the original estimate of $1 billion to $3 billion, now to in excess of $4 billion. The revelation underscores the importance of what has been previously observed by many, and that is our current regulatory oversight is not adequate.

To those who point out that this is an announcement of an increase in revenue, not losses, we should not miss the troubling point of this news if you were a shareholder of Freddie Mac. If you sold your interest in the company before the balancing adjustment was corrected, you were denied your fair distribution of company earnings by this unfortunate manipulation. I believe you will find adequate legal filings now on record to confirm this view.

More importantly, the explanation given for the misstep is that the corporation did not have enough properly trained staff to oversee its complicated derivatives portfolio. Why were they exempted from Sarbanes-Oxley? I ask again. Where was the regulator during the 3 years this error was unreported? If Freddie did not have enough invested in staff to properly oversee these complex activities, how can anyone argue that OFHEO was properly supported for the same purpose?

We should be more than just concerned. In fact, we should feel like any other corporate CEO in America whose oversight has been found lacking. These enterprises are our creation and clearly our responsibility Today, nothing stands between corporate losses and the American taxpayer except the regulators. We are the regulator of last resort.

In spite of this circumstance, some may suggest that any examination of the GSEs will result in market instability and potentially throw unsuspecting victims out of the opportunity for homeownership. I have only one question to ask. How is that a now readjusted restatement figure, up from $3 billion to now in excess of $4 billion, over a 3-year period of operations, has not crippled corporate activity and the housing market generally? Is there any action this Congress could take that could possibly approach the significance of these revelations? When such disclosures were made by Enron, WorldCom and other corporate wrongdoers, the consequences were devastating to employees and shareholders alike. The value of corporations was decimated, and some executives are now in court defending their actions.

What is even more troubling than the restatement at Freddie Mac is the realization that market observers looked past the corporate misstatements and directly into the taxpayers's pockets. There was no reason to be concerned as an investor about corporate misconduct, as long as the taxpayers were standing by ready to pick up the loss. This is, in my opinion, the most troubling aspect of all. What stands between corporate losses and the taxpayers's pocket is the regulator and not much else.

Looking to the current structure, in fairness, the effort made by OFHEO has been significant in light of the resource limitations placed on them. If Fannie and Freddie were regulated the OCC and were commercial banks, they would be assessed by formula almost a $70 million charge for their regulatory purpose. We have fought difficult battles in the Congress to get OFHEO to a $30 million level. Either the OCC really has it wrong or OFHEO is dramatically underfunded. I think I know which it is.

However, these problems have persisted for too long. It is no longer possible just to put a coat of paint on the walls at OFHEO and regain the respect of the marketplace. It is time to construct a new regulatory mechanism. It must be funded by assessment on the enterprises. It must have real authority to act on par with other financial regulators. It must be constructed to ensure independence and marketplace credibility.

H.R. 2575 is built on these principles. I have not proposed any controversial modifications to the charters of either GSE. I have not suggested a repeal of the current line of credit to the U.S. Treasury. I have not included the Federal Home Loan Banks in the proposal. This is a narrowly drawn, carefully crafted resolution intended not to create political debate, but to effect real change.

The legislation is carefully constructed to bring about only three goals. One is to ensure we have an independent regulator. Two is to ensure there is reasonable funding for the supervision. The third is to equip this regulator with all the necessary tools any other financial marketplace regulator utilizes. That is it. There should be no controversy over the legislation at all in light of the revelations over accounting irregularities. However, where there are identified concerns that can be supported by logical argument, I am certainly open to any constructive modification that gets us to the stated goals of this effort.

Some may suggest an alternate location for the regulatory home. That is fine. Others may have some objection to a particular enforcement authority. We will examine it, but I cannot envision such disagreements resulting in a failure to act on the overall mission.

To date, we have been fortunate in that no significant reversal in the housing market has occurred on our watch. But do not forget these enterprises exist as a result of congressional action that created them. They continue their favored market position with our concurrence. As long as there is profit to share, the market works well and shareholders are happy.

The Congress is, however, directly responsible for their supervision and regulation. If we fail in this effort by failing to provide minimal resources for a competent regulatory structure, the fall could be disastrous. When a GSE fails, it will quickly fall through its limited capital, right through the shareholders, directly to the taxpayer. That is an outcome we cannot accept. H.R. 2575 is a modest step to give us some assurance we take all appropriate actions to prevent that from ever happening.

I began my remarks this morning revisiting the events of June 15, 2002, the day Arthur Anderson was found guilty of obstruction of justice by a Texas court. Another historic event occurred just 24 hours earlier on June 14, 2002, not receiving near as much attention. An object known as 2002 NM passed within 75,000 miles of Earth, to be known in astronomical terms as a “near miss.” How close is that really? Well, the moon is about 137,000 miles away. So this object passed inside the orbit of the moon. As far as we know, this was the second closest near miss in human history.

So what else is significant about this event? Well, how about this fact: Scientists on earth did not know about 2002 NM until three days after its passage. How is this possible in this world of scientific technological sophistication? The answer is simple. We don't have enough resources committed or enough people watching to assure against a clearly cataclysmic event from occurring.

Now, I do not want to turn this hearing into a science and technology assessment, but the parallel is clear. Unless we act to enhance our supervisory capacity of the two housing GSEs that Congress has created, we may not see the next systemic event coming until it is too late. I sincerely hope that is not the committee's decision. Today, we will hear from four different individuals about their concerns and their recommendations for action this committee may consider. It is my hope the committee will find the adoption of H.R. 2575 as an appropriate next step in this most important responsibility.

[The prepared statement of Hon. Richard H. Baker can be found on page 47 in the appendix.]

Mr. Kanjorski, you are recognized.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Maybe as an aside, we should move through this and adjourn as quickly as possible so we can return to our families.

[LAUGHTER]

Mr. Chairman, our nation's system for housing finance is not only extremely successful, but it is also the envy of the world. Almost 68 percent of Americans own the homes in which they live. Government-sponsored enterprises have contributed greatly to this accomplishment.

This success, however, should not stop us from asking whether or how we can do a better job with respect to regulating Fannie Mae and Freddie Mac. We should also examine ways by which we can improve regulatory efficiency and lower mortgage rates. The recent events at Freddie Mac related to its earnings restatement and its management changes have highlighted the need for continued examination of these matters.

As you know, Mr. Chairman, I am also one of the few remaining members of the committee who participated in the entire congressional battle to resolve the savings and loan crisis. I am therefore acutely aware of the need to protect taxpayers from risk. It is in the public's interest that we ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We must further ensure that these public-private entities achieve their public responsibilities for advancing homeownership opportunities.

We can best achieve these dual objectives by pursuing a three-pronged supervisory approach that includes regular congressional oversight of, sustained effective government regulation over, and increased market discipline for the two GSEs. Through our extensive studies and hearings over the last 40 months, we are fulfilling our obligation in the Congress to conduct regular oversight of the GSEs.

Although we have not reached consensus on legislative reform during the last dozen hearings on GSE regulation, I do believe we have reached agreement on at least several key points. First, we have agreed that we have the world's most successful housing finance system and gained an appreciation for the important role that the GSEs play in the system. Secondly, we have agreed that Fannie Mae and Freddie Mac have grown significantly in recent years. Finally, we have agreed that we must have strong regulators for the housing GSEs.

As I said at our very first hearing on GSE regulation in March 2000, "We need to have strong, independent regulators that have the resources they need to get the job done." I continue to support strong GSE regulation. A strong regulator, in my view, will protect the continued viability of our capital markets, ensure against systemic risk, and expand housing opportunities for all Americans.

To ensure that we have strong GSE regulation, I believe that any legislative reforms considered by the Congress in the future should adhere to at least five key principles. First, in order to conduct robust supervision, a strong regulator must have a funding stream separate and apart from the annual appropriations process. Second, a strong regulator must have a single leader for a set term with sole responsibility for making decisions. Third, a strong regulator must be independent and free from political interference. Fourth, a strong regulator must focus like a laser exclusively on GSE issues. And fifth, a strong regulator must have enhanced supervisory and enforcement powers similar to those of other federal regulators for financial institutions.

The primary goal of today's hearing is to advance our examination of what structural changes might be necessary at the Office of Federal Housing Enterprise Oversight or the Department of Housing and Urban Development to ensure comprehensive and complete oversight of Fannie Mae and Freddie Mac. Today, we will hear primarily from one side of the debate: those who have often been critical of the GSEs and their regulators. In fact, many of our witnesses have already called on the Congress to reform GSE regulation, alter their statutory structure, or disband these entities entirely.

Nonetheless, as we proceed in the future, it is my hope that we will develop a balanced, deliberate and bipartisan plan of action for addressing GSE matters. In other words, we should move judiciously and objectively in conducting our oversight responsibilities. We also should understand the facts behind the current and recent events at Freddie Mac before considering any legislation.

Moreover, we should not once again upset the securities markets. On at least one occasion, our committee's actions have unfortunately discouraged investors and raised homeownership costs. As we proceed today, we must renew our efforts to ensure that we do not repeat that mistake.

In closing, Mr. Chairman, I commend you for your continued leadership on these issues. I will continue to work with you to conduct effective oversight over the housing government sponsored enterprises and to ensure that we maintain an appropriate and sufficiently strong supervisory system over them.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 54 in the appendix.]

Chairman BAKER. I thank the gentleman.

Mr. Ose?

Mr. OSE. Thank you, Mr. Chairman.

I would like to thank you also for your continued hard work on this issue and for holding this hearing today. You obviously are dedicated to a strong financial market, to disclosure and accountability, and both the membership and the country is well-served by that. Mr. Chairman, recent actions at Freddie Mac have led many in the public and on the Hill to take a closer look at how government-backed institutions are regulated. Specifically, many are asking if greater disclosure and accountability requirements are necessary. This is a serious question and one that we must examine very carefully.

Of particular concern is whether or not the current agencies with oversight authority have the ability, authority and personnel to properly regulate this vital industry. Let us look at just one part of such authority and the questions that it raised in recent weeks, the authority of the Office of Federal and Housing Enterprise Oversight, OFHEO, to oversee executive compensation at the GSEs.

When the accounting irregularities led Freddie to review its past actions here recently, the board at Freddie apparently was upset enough at executive actions to fire one senior executive and to ask two others to resign. However, these three individuals were still eligible for extremely generous compensation packages and stock bonuses. OFHEO reported said these would not be paid out until an investigation was carried out. You and I wrote OFHEO asking what authority they had to freeze such payments and whether their orders were being carried out. To date, there is still conflicting information on this question. I hope we will get clear answers soon.

Perhaps part of the trouble is that OFHEO is not home to the experts on financial services matters. The Department of Housing and Urban Development does many praiseworthy things, but it is just not experienced as regulating a financial market. I am pleased to join with you in offering the legislation, H.R. 2575, to move the oversight authority to the Department of Treasury, where there is a greater depth of experience on financial oversight and a far greater likelihood of proper oversight.

Mr. Chairman, I would like to thank you for taking a closer look at this industry. Liquidity and soundness in the housing marketplace is crucial. So is accountability. I look forward to hearing from our panel today and I look forward to the hearings on this matter in the future.

Chairman BAKER. Thank you, Mr. Ose.

Mr. Scott?

Mr. SCOTT. Thank you very much, Chairman Baker, Ranking Member Kanjorski.

I certainly want to concur with my colleague and commend you, Chairman Baker, for your insight and your knowledge on this issue and this industry. I certainly look forward to working with you as we develop legislation that will certainly address this problem.

As I have said before in this committee, no program is so good that it should not be reviewed. The public's confidence in our financial institutions is paramount to this country and the welfare of our economic system. Our nation is staggering under scandal after scandal of accounting practices of some of our most revered and large and impactful financial and economic institutions. It is especially important that Freddie Mac and Fannie Mae have meaningful oversight of their safety and soundness because of the implicit guarantee that the United States treasury will intervene, rather than let them fail.

Over the last 10 years, the housing GSEs have had their obligations rise from $1 trillion to $3.2 trillion. With this increase in credit risk and the recent accounting problems that Freddie Mac had with Arthur Anderson, Congress should ask questions and we will ask questions, and we get some answers. A financial crisis at either company could shake our entire domestic economy.

With that said, I believe that we must keep oversight focused on what is best for the consumers and the marketplace. Freddie and Fannie do serve important roles in housing markets, especially when they focus on their core missions such as increasing minority homeownership. From 1998 to 2002, African American homeownership rates rose from 45.6 percent to 47.3 percent, compared with the overall national average increase from 66.3 percent to 67.9 percent. With interest rates at historical lows, I believe that we must push even harder to help increase minority homeownership rates.

Freddie Mac and Fannie Mae have brought stability to the housing market. I believe that when they focus on their congressionally mandated mission, they provide a vital tool for market stabilization. That is one reason why I hope that Fannie Mae will reach a reasonable agreement with the manufactured housing industry to provide 30-year home mortgages.

There are some very serious questions that we need to raise this morning and get some answers to. For example, in the Monday New York Times, there was an article that questioned Fannie Mae's financial reporting. The article stated that a big loss last year was obscured by accounting complexities. I think we need to figure out if Fannie Mae's accounting practices show the true net value of assets. And for the Office of Federal Housing Enterprise Oversight or OFHEO, we need to question if with just 140 full-time staffers and an operating budget of $30 million, is OFHEO up to the task of regulating Fannie and Freddie? Because in fact, they are monitoring the fiscal health of two companies that together own or back nearly half of this nation's residential mortgage debt.

Also, we need to ask the question, is it fair to judge Fannie Mae based upon Freddie Mac's missteps. And if Freddie Mac only understated their earnings, then why did they fire their CEO and then let their President and CFO leave? Serious questions that the American people are looking to get serious answers from.

So I look forward to joining with you, Chairman Baker. I commend you for taking the leadership on this and I look forward to working with you as we put forth a fair and balanced piece of legislation to address this issue.

Chairman BAKER. I thank the gentleman for his fine statement.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman. First, Mr. Chairman, I want to thank you for your hearings. You have shown strong leadership over the past years on the issue of GSEs. As we all know, the events of the past few weeks have made it clear that this committee will closely examine the regulatory structure for government-sponsored enterprises. These companies have been a vital part of promoting homeownership and bolstering the housing market over the past few years in particular. We all know during the tough economic times in the past three years one of the few bright spots has actually been the housing market itself. Because of the liquidity they provide, Fannie Mae and Freddie Mac have been an integral part of the vibrant housing market to have supported what I would call a fragile economy.

However, their importance to the housing market stresses why it is so vital that we have a sound regulatory regime for the GSEs. Fannie Mae and Freddie Mac have been at the forefront of disclosure, having taken steps that go above and beyond what most companies would provide. This year they took additional steps and met the requirements of the joint Treasury-SEC-OFHEO mortgage-backed security disclosure study. I just point that out because since Sarbanes-Oxley amends the 1934 SEC Act, it applies to SEC registrants, defined as issuers. Fannie Mae and Freddie Mac both agreed to register their equity securities under the 1934 Act. Therefore, when Fannie Mae filed their Form 10 and 10(k) with the SEC on March 31, 2003, they became a full, irrevocable registrant under the SEC as I would understand it, and as such are fully bound by provisions within Sarbanes-Oxley.

However, today's nearing obviously will go towards the problems that have erupted and will have to go towards OFHEO, obviously, and what has been brought into question rightfully so is the effectiveness of OFHEO as a regulator for the GSEs. Fannie Mae and Freddie Mac are too important to our nation's housing market to allow a lack of confidence to develop in their regulation. That is why we have to diligently, but cautiously, pursue regulatory reform. These companies have been leaders in safety and soundness and we have to ensure that investors continue to have faith in that fact.

That is why I want to again commend Chairman Baker for this hearing. That is why I believe that we are all here today to endorse taking strong steps to guarantee that the housing GSEs have a strong regulator. I think many of us also agree that we must work with the Treasury Department and the administration to ensure that any change to the GSE regulatory structure be done in a way that preserves the companies' roles as GSEs in a way that strengthens the effectiveness of the safety and soundness regulation without foiling the financial markets. So this committee is going to have to have a balance in the need for strong GSE regulation with the need to be sensitive to the housing markets.

I was joking with my good friend Sherry Boehlert, the Chairman of the Science Committee the other day when this first was all announced. Everybody was scrambling for a hearing in the Congress. I told Sherry since Freddie Mac uses electricity in their building he as the Science Committee maybe he ought to have a hearing on Freddie Mac. I think that this is the perfect venue here for the hearings and I want to just point out that if there is wrongdoing, it has to be gone after. We cannot tolerate that.

If there is slippage in the regulatory scheme, we have to correct it. I want to echo the comments of my colleague, Mr. Kanjorski, I think we have to do it also in a balanced way so that we in fact to not affect the markets and hurt a lot of innocent people. There is a difference with Enron where it imploded and 15,000 people weren't around to be saved. In this case, we need to do the right thing in the regulatory mechanism. We also need to do the right thing in the markets in fairness to all Americans.

Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

The opening statements today have sounded in some cases more like opening jury arguments than they have like opening statements. I join with Mr. Kanjorski in pointing to the remarkable success it is for our country, for our nation that we have the kind of widespread homeownership that we have. We certainly need to extend it more broadly. We need, as Mr. Scott points out, higher homeownership among African Americans and others. But the extent of homeownership by the middle class in this country is a remarkable success, and these institutions, these government-sponsored enterprises, have played a huge role in that. Homeownership is how the middle class develops wealth. It is how they save for their children's college educations; how they save for retirement. It is a great asset.

The housing market in this country in the last few years has been one of the few bright spots in a very bad economy, a lot of which has been driven by the available capital for housing and for homeownership. We certainly do need to pay close attention to these institutions. We need to make sure they are solvent and they are sound. But I have learned in my brief service on this committee that accounting is in fact surprisingly imprecise. It is not terribly surprising that with interest rates dropping precipitously as they have in the last couple of years, that there would be some imprecision in the accounting treatment of these two government GSEs given the nature of their business.

So before I prosecute someone or convict them, I would like to identify exactly what the problem was, whether there was anything that merits being compared to Enron or Arthur Anderson, and I certainly want to make sure that we do not choke off the supply of capital that has gone into making homeownership possible for the middle class.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman for his statement.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman. I want to thank you for convening this important hearing on the oversight of the GSEs. The recent management reorganization of Freddie Mac should give us all pause to assess how well the operations of these GSEs are being monitored by OFHEO.

Freddie Mac and Fannie Mae account for billions of dollars in mortgage-backed securities which are widely held by pension funds, mutual funds and individual investors. Given the complexity of these institutions and their importance to the secondary mortgage market, it is critical that their regulator be capable of exercising rigorous oversight to ensure their safety and soundness. Over the past six months, as Freddie Mac first announced that it would restate its earnings and then dismissed its three top officers, OFHEO has appeared to be habitually slow to act and unable to predict these crises.

Chairman Baker has been tireless in his review of the issues surrounding the GSEs and was instrumental in the agreement by both Freddie Mac and Fannie Mae to voluntarily register their securities with the SEC. This voluntary registration will lead to more transparency in the operations of the GSEs, which will make for a more efficient and better-informed marketplace.

The U.S. housing market has remained strong through difficult economic times and is the most sophisticated in the world. This is largely due to the liquidity provided through the secondary mortgage market in which Freddie and Fannie are the key players.

I look forward to hearing from our distinguished panel. Their insights as third party observers will be critical to our consideration of this issue and future actions this committee may take.

I yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page 46 in the appendix.]

Chairman BAKER. I want to express my appreciation to the Chairman for his participation here today and also to acknowledge that it has been with his leadership and counsel that we have moved to this point in the process, and recognize that this issue is obviously controversial and difficult, and I certainly appreciate his willingness to be a strong leader in the effort as well.

Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chairman.

Mr. Chairman, considering the recent events of the past two years regarding the validity of various companies' financial statements and the related fraud committed by the management of Enron to WorldCom, it is my understanding that Congress would want to take a careful look at its GSEs that are so critical to the homeownership market in this country.

Upon hearing about the removal of Freddie Mac's top brass and the accuracy of their financial statement was in question, all of us who have this primary responsibility for safeguarding the country's financial system had to have concern about the extent of the problem and be prepared for the necessary committee action.

However, I counsel prudence in taking legislative action based on the initial reports. All indications thus far are that the GSEs are still two of the best capitalized and financially solvent financial services companies in America. They have met OFHEO's risk-based capital standards and met their cooperative agreements for transparency. Once Freddie Mac registers its common stock, something Fannie Mae has already done, they will have completed another step in complying with additional calls for transparency.

There are individuals who believe that GSEs need a stronger financial regulator. There are others who are seeking greater regulatory control over their products and programs. Perhaps those concerns have some validity that needs further exploration. But let me tell you about my concerns. My concerns are that GSEs continue to help Americans achieve the highest homeownership rate we have ever experienced. I am concerned with GSEs's continuing to close the gap in minority and non-minority homeownership rates. My concerns are with the GSEs's continuing to make homeownership more affordable to low-and moderate-income individuals in America.

Of course, safety and soundness must be our primary concern as legislators. But we cannot let a rush to judgment lead us down the path of unintended consequences. The role of GSEs is too critical to our economy to have their mission interrupted. We must not throw the baby out with the bathwater and we must make sure that we keep and strengthen these institutions.

I yield back the balance of my time.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman.

I will be brief. I don't want the opening statements to overtake the testimony. I want to associate myself with your remarks in particular, and that of my colleague, the Chairman of the Housing Subcommittee, Congressman Ney. Look, Fannie Mae and Freddie Mac are a vital part of our housing finance system. I think we understand that. I think we also understand that nothing that we undertake here today or talk about here today is discussed in a vacuum. There are observers and there will be reactions. We must tread carefully because of the sensitivity to the potential responses by housing market observers.

On the other hand, I believe tread we must. People may not fully understand the role of Fannie and Freddie in our economy and the housing finance system. More importantly, they will never understand why we failed to take action when we could when we learned that there are in fact changes that need to be undertaken. So while we do need to tread carefully, again I think we have no choice but to take certain steps and tread we must.

With that, I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Ms. Maloney, by unanimous consent, not a member of the committee, but who would like to make a statement. Without objection, she is recognized.

Mrs. MALONEY. Thank you, Mr. Chairman. I request permission to put my comments in whole in the record, but to summarize it, I thank you for your leadership and would like permission to put in the record the lead article today in the American Banker, which outlines the work of this important committee.

[The following information can be found on page 104 in the appendix.]

I would just like to say that oversight of the GSEs is one of the most important issues the Financial Services Committee presides over. These institutions are pillars of our housing system and millions of our constituents benefit from the liquidity they provide our lending institutions.

At the same time, the recent events at Freddie Mac are deeply troubling. While the company's new leadership is trying to repair the damage, the reality of the accounting and corporate governance shortcomings that occurred at the company are unsettling given the size of the institution.

I joined this committee just as our country was emerging from the S&L crisis. My first vote was a huge bailout of these institutions. Because of this experience, I regard congressional oversight of the safety and soundness of the financial services industry as really our most important responsibility. In this regard, I have long supported efforts to provide more resources to the Office of Federal Housing Enterprise and Oversight and I joined the Chairman last year, along with Representative Bentsen and Kanjorski, in legislation that would have removed the agency from the appropriations process, thereby making it more independent.

I want to note that OFHEO took very, very long to come forward with its risk-based capital rule, but despite these shortcoming in OFHEO's history, I do believe in taking a deliberative and thorough approach to legislating major changes to our nation's housing markets. I understand the Chairman is coming forward with a total change to this, but I have not had a chance to look at that legislation. Before acting, we need to know exactly what happened at Freddie Mac and whether it represents a one-time occurrence or a systemic problem.

The U.S. mortgage market is the best in the world, as we all know, and in the current low interest rate environment mortgages are being refinanced at a record rate that would be impossible without automation from national laws like the FCRA and our incredibly successful mortgage finance system. The Washington Post detailed the impact that the ability to refinance so easily is having on our economy in a June 8 article. I request permission to put this article in the record. I just want to note that it pointed out that since 2001, banks have processed more than 27 million mortgage refinances by the end of this year, and in total since 2001 refinancing will have delivered about $300 billion directly to consumers who will have more money to spend and pump up the economy. That is in comparison to the $263 billion that the Bush tax cuts of 2001 and 2003 will have put into the economy by year's end. So I thank the Chairman for his oversight, for calling this hearing, and really for his leadership. I look forward to working with him to make sure that our housing system remains preeminent in the world. I thank him.

Chairman BAKER. I thank the gentlelady for her statement. Her statement, of course, and all ancillary materials referenced will be included in the record without objection.

[The prepared statement of Hon. Carolyn B. Maloney can be found on page 56 in the appendix.]

Mr. Bachus?

Mr. BACHUS. First of all, Mr. Chairman, I want to thank you for this legislation. I think it is a measured approach, and for your approach to these hearings. We are going to investigate the matters.

There has been absolutely no suggestion by anyone that Fannie and Freddie are not sound financially. What has been suggested, and I think recent events have borne out, and that is that OFHEO has failed to be the regulator that they needed to be. Your approach has been to shift regulatory oversight to the Treasury Department. That has been suggested for some years as the best approach. The Department of Treasury has years of financial regulatory experience and has proven to be up to the task.

Other than what the others have testified, I would simply add is evidence that we do need to transfer oversight and regulation to the Department of Treasury. The budget for OFHEO last year was

$27 million. Despite this, in their latest report to Congress, OFHEO certified that Freddie Mac's audit functions were independent and effective. So obviously they failed to do their job.

Now, it could be that they simply did not have the authority that the Treasury has, but your bill takes care of that by transferring it to Treasury and then OTS, and giving the regulator of Fannie and Freddie the same authorities as your other bank regulators have. So for whatever reason, it may have simply been that they did not have sufficient authority in their regulation.

One thing that I do want to express some reservation about, and I have discussed this with you, is the part of the legislation with regard to HUD's new program authority. I do not want to stifle innovation in the marketplace by micro-managing these new product issues. I think we ought to take a very careful look at that. But other than that, I think you have a good bill and I look forward to working with you.

Chairman BAKER. I thank the gentleman for his kind remarks and his cosponsorship of the measure as well.

At this time, the Ranking Member of the full committee, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

I want to apologize, first, because this committee has a bill on the floor which I will be managing. It is very important bill. It will be up this morning on suspension, to provide a gold medal to Tony Blair and I guess payback his legitimate part of things. So I will be temporarily absent while I preside over that important piece of legislation.

I just want to say that I am glad to hear members talking I think in very thoughtful terms. We are not talking about a crisis that is comparable to those that affected some of the major corporations. We have a general agreement that the important function of easing housing finance at the two big companies involved here is important to protect. I think it is very legitimate for us to look at what went wrong here and what, if anything, we could do legislatively to stop it. But I would include in this that this is an issue it seems to me not simply of Freddie Mac, but also of accounting.

I had not, I must say, prior to becoming the ranking member, paid as much attention to the accounting industry as my duties now require me to. I think part of the question now is I think to a good part of America, the issue is whether accounting more resembles astrology or alchemy in the way in which it is practiced. As we deal with the question of what is the appropriate structure for the GSEs, I think this is a reminder that we also need to look further in to the question of how we regulate the accounting industry because some of these issues are not just GSE-specific, but they are generic to the question of accounting.

That also includes, and I hate to say this because I cannot think of anything that would be less fun for us, but derivatives also is something we have to look into. I say that with all the enthusiasm of being told that we have to go back to trigonometry and take a test in it. But it does seem to me that, as I said, some of this is possibly GSE-specific, but much of it deals with generic accounting issues and derivative issues and I think these need to be on the agenda.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman for his remarks.

Mr. Gary Miller?

Mr. GARY G. MILLER OF CALIFORNIA. Thank you, Mr. Chairman. I applaud you for holding this hearing today and the approach you have taken on this issue has been very deliberative and reasonable. We all know that home equity appreciation is one of the most important drivers of wealth creation in the United States. By helping people become homeowners, we promote long-term economic stability for our nation.

Congress must continue its goal of helping millions of Americans to achieve the dream of homeownership by ensuring that Americans have access to mortgage funds at the lowest cost. Fannie Mae and Freddie Mac were chartered by Congress in 1970 to provide stability and ongoing assistance to the secondary market for residential mortgages and to promote access to mortgage credit and homeownership in the United States. It is imperative and important to ensure the safety and soundness of the secondary mortgage market.

The question of impropriety that has surfaced as a result of the revelation of accounting irregularities at Freddie Mac could be devastating to the strong housing market. We must examine whether OFHEO is truly up to the task of regulating Freddie and Fannie. It is our responsibility to examine the situation and understand how Freddie Mac's regulators could have released an annual report that the audit functions at Freddie Mac were effective and that the internal-external audit functions had the appropriate independence necessary. This was a mere three days before Freddie Mac's announcement that its top three executives were being ousted because of accounting irregularities.

As we proceed with our examination, we must be cautious and deliberative. Chairman Baker has proposed creating a new safety and soundness regulator in the Treasury Department with independent funding, reasonable enforcement authority, and sufficient standing to provide Congress and the investigators a clear and accurate financial assessment of GSEs. We must be mindful that our ultimate goal is to expand the supply of affordable mortgage credit in order to stimulate the production of affordable housing. As we move forward, we must be sure we completely understand the implications of changes in the regulatory structure in meeting this important goal.

In California, we have had some very difficult economic times and the housing industry has really kept California afloat, and this is a tremendously important issue for California.

I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

At this time, I don't know that there are other members on the Democrat side to be recognized.

Let me ask it this way, are there others wishing to make an opening statement at this time?

Mr. CROWLEY. Mr. Chairman?

Chairman BAKER. Mr. Crowley?

Mr. CROWLEY. Thank you. Mr. Chairman, I want to express my pleasure in your holding these hearings and at the same time express some concerns about what I believe may be too broad an approach when we are examining these issues. There is no question that the troubles of Freddie are troubles we on both sides of the aisle are concerned about. We know that Fannie Mae right now registers with the SEC so its corporate documents can be disclosed to the public and investors.

What I really question is why we are focusing on all the GSEs when not all of them have problems. In fact, Fannie has received clean financial reports. It is as if we looked at Coca-Cola and saw that they had problems in their accounting and then also looked at Pepsico; or if we go a little further, examining Halliburton after the failure of Enron. I do want to recognize that both these entities, as mentioned on the other side, are sound institutions and have historically provided great opportunities for Americans. I just don't want to see, and I don't think this committee will do that, Mr. Chairman, with your leadership, a degradation of these two institutions. With that, I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Royce, did you have an opening statement?

Mr. ROYCE. Thank you, Mr. Chairman.

I want to thank you for holding this hearing. I would like to commend you for your unwavering commitment to the topic of GSE regulatory reform. I also greatly look forward to hearing from our witnesses today to see what they have to say to contribute on this ongoing discussion.

Government-sponsored enterprises have really focused on homeownership and have been around since 1934. Since that time, they have played an important role in developing the secondary mortgage market in the United States. Fannie Mae and Freddie Mac buy mortgages from originators in order to provide liquidity in the market. The Federal Home Loan Bank system provides advances to banks and thrifts so that those organizations can offer mortgage products to their customers.

Like the rest of corporate America, the GSEs have developed comprehensive business models to achieve their mission and to get results for their shareholders. As a result, the housing GSEs have become three of the most sophisticated financial institutions in the world. In total, the three GSEs have over $2 trillion in debt and a derivative portfolio with a total of $1.9 trillion. As a result of their evolving business models, the three housing GSEs now must protect their balance sheet not only from credit risk, but also from interest rate risk.

With these facts in mind, I think that it is crucial that these organizations are subject to competent regulation. I regret to say that I do not have enough confidence in the Office of Federal Housing Enterprise Oversight which regulates Fannie Mae and Freddie Mac, or in the Federal Housing Finance Board which regulates the Federal Home Loan Bank system.

I believe that we need to fold these two regulatory bodies into a new agency under the umbrella of the Treasury Department. In my view, such a regulatory institution will have better direction through its association with the Treasury and its sister regulators, the OCC and the OTS. The new regulator will also have the ability to achieve best practices of regulation because it will have a broader scope than either OFHEO or the FHFB has today, and it will be focused on protecting the taxpayer from like-types of systemic risk.

I think that it is important for this committee to act on this matter through perception and reality or both. All three housing GSEs are inadequately regulated. I look forward to working with my colleagues to create a new, more effective regulatory structure for Fannie Mae, Freddie Mac and the Federal Home Loan Bank system.

I would like to thank our witnesses here today and would once again like to thank Chairman Baker for his longstanding interest in this issue.

I yield back the balance of my time.

[The prepared statement of Hon. Edward R. Royce can be found on page 58 in the appendix.]

Chairman BAKER. I thank the gentleman for his remarks.

Ms. Harris?

Ms. HARRIS. Thank you, Mr. Chairman.

I want to express my appreciation for your willingness to conduct these hearings on the oversight of the government-sponsored enterprises. This morning we will consider the oversight body of Fannie Mae and Freddie Mac, focusing upon the structural changes that may be necessary to improve the oversight of these two GSEs.

As this committee examines the proposed reforms, we must recognize the vital role that both Fannie Mae and Freddie Mac play in maintaining the health of our nation's housing industry. The housing industry serves as the backbone of our American economy, having enjoyed vibrant growth and economic prosperity while other sectors of our economy have struggled recently. In particular, I believe we must remain aware of the impact that additional hearings or legislation could have upon the housing industry and global markets. Our actions could provoke unintended consequences in the market for mortgage-backed securities.

Recent events have prompted multiple agencies to investigate the accounting operations of Freddie Mac. I hope these investigations will produce findings that can help us frame the legislation that will alleviate the concerns that these events have created, while preserving those positive contributions that Freddie Mac has made to the housing industry.

I wish to thank the individuals who are here today on our panel for their insights regarding the oversight of Fannie Mae and Freddie Mac, and moreover I look forward to a healthy debate regarding this critical matter.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentlelady.

Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Chairman, I would like to submit a written statement, but just say that we are looking at two fine companies in Fannie Mae and Freddie Mac, the second and fourth largest financial institutions on the New York Stock Exchange. Fannie is under the 20th largest company; Freddie the largest under 40th. I mean, these are huge and important companies. But it blows me away that they are not by law under the 1933 and 1934 Securities Acts. When we dealt with Enron and WorldCom, all those reforms did not apply to them because they were under the SEC requirements and they were not part of it. It blows me away they pay no federal and state taxes. They are not under the privacy laws, state consumer laws, truth-in-lending laws. I am amazed that they are under a regulator that has half the resources, and I feel quite candidly that they tell the regulator what to do, not vice versa. I am hoping that your legislation will move forward. We will have a stronger regulator. It will be under the Treasury Department. I hope they will have greater powers and will treat this on a level playing field.

I do not fault Fannie and Freddie for not wanting to have to play by the rules that everyone else plays by, but I do fault Congress for not addressing this issue. I am grateful that we are beginning to.

Chairman BAKER. I thank the gentleman for his statement.

[The prepared statement of Hon. Christopher Shays can be found on page 59 in the appendix.]

If there are no members desiring to make any further statements, at this time I would like to recognize our first witness. Welcome to each of our panelists this morning for your endurance.

Our first witness is Mr. Sean Egan, Managing Director of Egan-Jones Rating Co. Welcome, sir.

Let me quickly add, all statements will be made part of the official record. To the extent possible, if you can constrain your remarks to five minutes, it will enable the committee to engage in more thorough questioning. We appreciate your participation.

Welcome, Mr. Egan.

STATEMENT OF SEAN J. EGAN, MANAGING DIRECTOR, EGAN-JONES RATINGS CO.

Mr. EGAN. Thank you.

Chairman Baker, members of the subcommittee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit rating firm. By way of background, I am the Cofounder of Egan-Jones, which was established to provide timely accurate ratings to institutional investors.

Our business model differs significantly from other rating agencies in that we are not paid by issuers of debt, which we view as a conflict of interest. Instead, we are paid by approximately 300 firms consisting mainly of institutional investors and broker-dealers. Unlike the major rating firms, we provide early warning to investors on major debacles such as Enron, WorldCom, Global Crossing, Genuity and ABB. We are based in the Philadelphia, Pennsylvania area, although we have employees that operate from other offices.

The three areas I would like to briefly address today are the GSEs's current status, their development, and our proposed reforms.

Regarding their current status, Fannie Mae and Freddie Mac, collectively the GSEs, started life under the protection of the federal government and were given a line of credit from the U.S. Treasury. When they were small, the $2.5 billion line of credit was adequate. However, as they have grown, that line has become inadequate. I direct everyone's attention to the chart that we have on the first page of my written testimony. That is a list of the asset base of Fannie Mae and Freddie Mac. If you look at the asset base, as of the year 2000, they had $675 billion in total assets. That is the first line. It grew in 2001 to approximately $800 billion and in 2002, to $877 billion.

The next line is shareholders equity. It is interesting. It went from basically $21 billion down to $16.3 billion. They reported profits last year. I don't think they paid out $2 billion in common stock dividends, so it is still a mystery how they went from $18 billion to $16 billion, but they did it. The more telling figure is equity divided by assets. In the year 2000, it is 3.1 percent. It dropped down to 1.9 percent in the year 2002.

Freddie Mac, interestingly, its equity to assets looks fairly reasonable. However, we are always skeptical of some of these accounting results. It is very easy with derivatives, to manipulate the valuation of derivatives. Keep in mind that the GSEs are providing a lot of liquidity for these derivatives to bolster the earnings and capital account.

What we take away from these two charts is that 1.9 percent equity to assets and the 3 percent is really just a sliver. It is a sliver of capital for institutions that have huge positions.

Let me move on. As the GSEs grew, they were not able to grow their capital base sufficiently to keep pace with the rapid asset growth. What used to be high leverage has become excessive leverage. Below is a comparison of the GSEs's current ratios to other firms' ratios. It is difficult to find perfect comparables to the GSEs. They are unique institutions in some regards, but there are some that at least provide some guidance. You see in the second chart on page two, Countrywide Financial which is rated by Moody's A3, by S&P an A. You see the total debt-to-capital is 89 percent. It means that they have roughly 10 percent capital. That compares to Fannie Mae's less than 2 percent capital. It just means that there is a big difference, but yet they are given a AAA rating.

Let me move down. Egan-Jones currently rates Fannie Mae at A+, which is approximately four notches below S&P and Moody's AAA ratings. Egan-Jones uses the same rating categories as S&P in the investment-grade segment.

Attached is a history of our ratings and below our comments from a June 10, 2003 report on Fannie Mae. This is quoting from the report. "Far from a AAA, Fannie Mae is not fully backed by the U.S. and only has a sliver of equity. The general rule for banks is to maintain equity at 8 percent of assets. Fannie Mae has only 1.96 percent. Also, Fannie Mae has greater volatility than some banks because of its business focus and absence of loan prepayment penalties." In other words, if you borrowed from a bank and if you want to prepay that bank loan, you have to pay a penalty because a bank normally is match-funded with liabilities so they don't have to worry about prepayment. In the case of Fannie Mae and Freddie Mac, they don't have that.

Although Fannie Mae claims that it is hedged, there are few perfect hedges. Keep in mind, they are one of the biggest hedging institutions probably in the world. Most traders say there are very few perfect hedges. That applies here. Still unresolved is the support Fannie Mae will get from the federal government if it gets into trouble. Fannie Mae's prospectuses state that the federal government is under no obligation to support Fannie Mae, but most investors assume it will, probably up to only $2 billion. The assumption of the U.S. guaranteeing all Fannie Mae's debt and shareholders getting the up-side is likely to change.

Egan-Jones currently rates Freddie Mac at A, which is approximately five levels below S&P. Let me skip forward. We have similar comments on Freddie Mac. A reasonable question would be why one rating agency, Egan-Jones, would rate the GSEs at A and A+, whereas Moody's and Standard & Poor's and Fitch would rate the GSEs at AAA. Our view is that, number one, there is substantial pressure on major rating agencies to maintain a high rating for various large issuers. Number two, there is relatively little penalty if the rating ultimately proves to be wrong.

Regarding pressure to maintain a high rating, Moody's, Standard & Poor's and Fitch obtain approximately 90 percent of their revenues from issuers such as the GSEs. I am quoting from the Wall Street Journal. Over the years, S&P and Moody's have rated over $500 billion of Freddie Mac debt and earned tens of millions of dollars of fees. They don't tell you exactly how much they have earned, but if you use their standard rate of 2 basis points, that adds up to $100 million for one of the agencies for one of the GSEs. That is a lot of money. It has to be one of their biggest clients, if not their biggest clients.

Unlike Moody's, S&P and Fitch, Egan-Jones is not paid by the issuers for its ratings. Regarding the lack of penalty if Moody's, S&P and Fitch ratings prove to be disastrously wrong, there are relatively few alternatives. The major rating agencies therefore face few penalties. Up until earlier this year, the three major rating firms were the only firms recognized by the SEC, and DBRS which was recognized in March 2003, has little market presence in the U.S.

Over the past 3 years, there have been numerous examples of investment-grade firms filing for bankruptcy protection on short notice. Enron was rated investment-grade four days before it's filing. National Century was rated AAA 2 months before it's filing. WorldCom was rated at the Baa/BBB level 3 months before filing. The California utilities were rated at the A level 16 days before defaulting. Despite these failures, the major rating firms have regularly grown their revenues because of the restrictions on competition.

We have several suggestions.

Chairman BAKER. Can you begin to conclude for us, too?

Mr. EGAN. Yes. We have several suggestions that are listed in the report. One is the establishment of a revised regulatory body. You can read that. Two is restricting the growth, rebuilding the capital of the GSEs. Three is encouraging the development of additional funding sources. I don't care if these GSEs are the best-managed entities in the history of the world, things happen. My teenage son might have put it slightly differently. You can't concentrate on just two agencies. If a bomb explodes in their computer center, you don't want to shut down the country. Four is enhance the ratings firms' independence. This is an important issue. We think that it has to be addressed. If it is left unaddressed, it will continue to fester and cause additional problems.

[The prepared statement of Sean J. Egan can be found on page 72 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Egan. Your full written testimony will be made part of the record as well.

Our next witness is Mr. Thomas Schatz, President, Citizens Against Government Waste. Welcome, sir.

STATEMENT OF THOMAS SCHATZ, PRESIDENT, CITIZENS AGAINST GOVERNMENT WASTE

Mr. SCHATZ. Thank you very much, Mr. Chairman and members of the subcommittee. I appreciate being here today on behalf of Citizens Against Government Waste.

We are pleased to testify about the adequacy of oversight of Fannie Mae and Freddie Mac. We agree that Fannie Mae and Freddie Mac provide a very useful service to the American economy. We also believe that these organizations should ultimately be privatized.

That being said, we do support reasonable regulation as well as greater accountability and transparency as interim steps toward full privatization. Thanks to your good work, Mr. Chairman, and the hearings you have held over the last several years and the work of this subcommittee, improved regulation of the GSEs has been amply examined. It is now time to act. Certainly the changes that have been made at the GSEs in terms of voluntarily registering with the SEC and other steps they have taken have been as a result of the work of this committee.

The current system of GSE oversight certainly does need improvement. Freddie Mac is the fourth largest financial services company in the United States, yet as others have pointed out, it's safety and soundness regulator, OFHEO, gave Freddie Mac a clean bill of health less than a week before the announcement of the company's accounting problems.

My written statement includes 15 suggested improvements for GSE oversight, and I would like to mention a few of them now. Strengthen safety and soundness regulation by moving this responsibility to the Department of the Treasury and provide the new regulator with powers comparable to those available to bank regulators; require that the GSEs hold bank-like capital, and Mr. Egan pointed out the differences between the capital held at banks and other financial institutions and Fannie Mae and Freddie Mac; fund the regulator through assessments on the GSEs; permit new programs as long as they do not violate the GSEs's charters or undermine the safety and soundness of the GSEs and also do not involve direct consumer lending; repeal Fannie Mae and Freddie Mac's exemption from federal securities laws; and finally, repeal the line of credit of $2.25 billion that exists for each GSE.

We recognize that our list is ambitious, yet you have included a number of these provisions in your new bill, Mr. Chairman. The three provisions we believe are essential right now are bank-like capital for Fannie Mae and Freddie Mac; consolidation of safety and soundness and new program authority in a single strong regulator; and repeal of the GSEs's exemption from federal securities laws.

Mr. Chairman, we support your bill's establishment of prompt corrective action powers for the new regulator, but again we reiterate Fannie Mae and Freddie Mac should be subject to the same capital standards as banks. In March of this year, William Poole, President of the Federal Reserve Bank of St. Louis, recommended that, quote, "Over a transitional period of several years, the GSEs should add to the amount of capital they hold," unquote. I ask, Mr. Chairman, that the entire text of Mr. Poole's speech be included. I have attached it to my statement. Without the imposition of stricter capital standards, the GSEs will always pose a problem of systemic risk to taxpayers.

CAGW supports your plan to move the GSEs's regulator from HUD to Treasury and to make it more independent by removing it from the appropriations process, and financing it through the assessment of fees on the two GSEs.

We also believe that new program approval should come under this new Treasury regulator, as most of the new programs that GSEs propose are financial products. The possibility of systemic risk posed by the GSEs is inextricably tied to the scope of their activities.

Finally, we believe your bill should include provisions comparable to H.R. 2022, legislation introduced by Representatives Chris Shays and Ed Markey, to repeal the GSEs's exemption from federal securities laws. This month's news regarding Freddie Mac clearly demonstrates the implication of the GSEs's current exemption from these laws. Any other company which was forced to restate earnings must continue to file its financial statements with the SEC or be subject to SEC sanctions. In such cases, the message is clear to investors that the company has not complied with the law. In Freddie Mac's case, despite its failure to live up to its commitment to register, the agency did nothing and in fact did not initiate an investigation of Freddie Mac until after the company's announcement of its management shakeup. Certainly, no other public company would have experienced such forbearance from the SEC.

We endorse the view of the Treasury, OFHEO and the SEC in February in terms of MBS disclosure which concluded that any adverse effects from additional disclosure will be short-term and will be outweighed by the benefits of greater information flowing into the MBS market. The Congressional Budget Office agreed with this last month, and last week Moody's Investor Service stated that making all GSE securities subject to SEC registration would be a good thing. These financial giants should be held to the gold standard of disclosure, as both former SEC Chairman William McDonough and Federal Reserve Chairman Alan Greenspan have said.

Mr. Chairman, we commend the subcommittee for its continued oversight and efforts to improve the management of the GSEs. The time for inquiry is over. We believe it is time for action to be taken by this Subcommittee to exercise its responsibility to the taxpayers. We urge members of the subcommittee to enact legislation that will establish a strong regulator with the authority to impose bank-like capital standards and repeal the GSEs's exemption from the securities laws. Thank you, Mr. Chairman.

[The prepared statement of Thomas A. Schatz can be found on page 85 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Dr. Jay Cochran, Research Fellow at the Mercatus Center, George Mason University. Welcome, sir.

STATEMENT OF JAY COCHRAN, RESEARCH FELLOW, THE MERCATUS CENTER, GEORGE MASON UNIVERSITY

Mr. COCHRAN. Good morning, Mr. Chairman, Mr. Kanjorski, members of the committee. I am Jay Cochran, a Research Fellow in Regulatory Studies at the Mercatus Center at George Mason University, and adjunct professor of economics at GMU.

Our mission at the regulatory studies program is to advance knowledge of the impact of regulations on society from the perspective of the public interest. Therefore, our work does not represent the views of any particular affected party or special interest group, but rather is designed to evaluate the effects of government policies on overall consumer welfare. I would like to emphasize, however, for the record that my comments today do not represent an official position of the university.

In 2001, Catherine England, professor of finance at Marymount University and I authored a study entitled "Neither Fish Nor Fowl: An Overview of the Big Three Government Sponsored Enterprises in the U.S. Housing Finance Markets." The big three, of course, being Fannie Mae, Freddie Mac and the Federal Home Loan Banks. I respectfully request, Mr. Chairman, that this study be incorporated into the record as part of my remarks here today.

Chairman BAKER. Without objection.

Mr. COCHRAN. Our aim then, as now, in writing this study was to bring a measure of objectivity to a subject that, as I am sure everyone on this committee is well aware, can be quite contentious. This morning, I will briefly touch on some of the risks presented by the GSEs, as well as some of the oversight and regulatory issues pertaining to them.

First with respect to risk, the big three GSEs on balance sheet assets have grown since 1995 from $726 billion to just under $2.4 trillion by the end of 2002. Mr. Chairman, in my written testimony provided earlier, that was a misprint and said $2.4 billion. It should read $2.4 trillion. This represents an annual growth rate over the period of more than 18 percent per year. By comparison, real GDP over the same period grew by roughly 3 percent and the overall U.S. residential mortgage market grew by slightly more than 9 percent per year.

By itself, rapid growth is not necessarily troublesome so long as general principles of financial safety and soundness are followed. Of course, one of the most important principles of sound finance is diversification. That is, not having all of one's eggs in one basket. For the last several years, though, Fannie Mae and Freddie Mac have been placing more of their own eggs in their own basket. They have gone from holding a combined $125 billion of their own mortgage-backed securities in portfolio in 1995 to holding nearly $850 billion of their own MBS internally as of 2002, a growth rate exceeding 30 percent per year.

In this connection, it is well to recall that Congress's original aim in creating the GSEs was to help the banking and thrift industries off-load and spread the risks of mortgage finance by creating an active secondary market in mortgages through the GSEs. If, however, the GSEs are increasingly holding their own mortgage-related products in portfolio rather than selling them to investors, mortgage lending risks may again be concentrating rather than dispersing throughout the economy.

To their credit, the GSEs cite adequate risk protection through hedging activities and by other means. However, such claims raise the issue of counter-party risk. Are the institutions on which the GSEs rely for risk-sharing financially sound? And just as importantly, are they likely to remain so during less than ideal economic conditions? But even beyond the basic question of financial soundness, if banks are important counter-parties to the hedging and risk-control operations of the GSEs, then in an important if less obvious way, the risks attendant with mortgage finance may be quietly reentering the banking system, only this time through an off-balance sheet side door.

With respect to Fannie Mae's and Freddie Mac's safety and soundness regulation in particular, I trust that the staff of OFHEO is well intentioned and doing the best job that they can, given the economic and political constraints that they face. However, no realistic assessment of GSE oversight can ignore the fact that OFHEO consists of just over 100 people operating on a $30 million annual budget. Yet this small organization is expected to oversee two enterprises that hold a combined $1.6 trillion in assets and produce business volumes on a monthly basis measured in the billions of dollars. This vast disparity in size and resources may explain in part why, for example, OFHEO gave Freddie Mac and its audit procedures an unqualified endorsement, only to have that endorsement undermined by recent events.

It is also noteworthy that OFHEO took nearly 10 years to develop a risk-based capital standard for the GSEs. To be sure, the risk-based capital standard that emerged is a sophisticated and complex model. Still, I cannot help but be concerned given my earlier remarks about diversification, for example, that we may have substituted modeling sophistication for adherence to basic principles of sound finance.

In conclusion, I think the history is clear that the housing finance GSEs have delivered benefits, not only to their owners, but also to homebuyers and lenders. Despite these benefits, however, one must always keep in mind that the GSEs are neither fully responsive to market forces nor to government control. Being neither fish nor fowl, neither fully private nor fully public enterprises, prudence and rational public policy require that the GSEs undergo regular scrutiny by government and market participants. With respect to this last point in particular, Mr. Chairman, I would like to applaud you and the members of this committee for your steadfast willingness to undertake this difficult, but necessary responsibility.

Thank you.

[The prepared statement of Jay Cochran can be found on page 61 in the appendix.]

Chairman BAKER. Thank you very much, doctor, we appreciate your testimony.

Our next witness is Ms. Karen Shaw Petrou, Co-founder and Managing Partner of Federal Financial Analytics, Incorporated. Welcome.

STATEMENT OF KAREN SHAW PETROU, CO-FOUNDER AND MANAGING PARTNER, FEDERAL FINANCIAL ANALYTICS, INC.

Ms. PETROU. Mr. Chairman, thank you, and Mr. Kanjorski and members of the subcommittee, for inviting me here today to speak on the topic of improving the regulation for the housing GSEs.

I am Karen Shaw Petrou, Managing Partner of Federal Financial Analytics, a firm that provides information and consulting services on an array of legislative, regulatory and policy issues that affect the financial services industry. Our information service includes one on the GSEs, which is used by combatants on all sides of this debate. On our consulting and advisory services, our clients include U.S. and international bank regulators who we have assisted over the years in improving their own work.

We have been doing a great deal of work of late on the Basel Risk-Based Capital Accords and we also advise numerous firms and associations on concerns that Fannie Mae and Freddie Mac serve their homeownership mission, and not engage in new activities in a risky fashion.

Today, I would like to focus on tenets of effective bank supervision that I believe can be easily, quickly and appropriately adopted for Fannie Mae and Freddie Mac. There is I believe no evidence that effective bank supervision and meaningful capital requirements have in any way undermined homeownership. I think it is very important to remember that Fannie and Freddie cannot serve their mission and promote homeownership unless America's financial services firms, banks and savings associations, first do theirs. They originate the mortgages. Fannie and Freddie then securitize them. Effective supervision has not inhibited the ability of lenders to originate mortgages and I do not believe it will be in any way an impediment to an effective secondary market that will promote homeownership.

In fact, as this panel has recognized in its work on the Basel rules, effective supervision and meaningful capital has been a key to the success of the U.S. financial services industry and especially our banking sector. We lead the world. Many of our institutions are the largest, and most importantly I think without dispute, American banks are the most innovative on derivatives and asset securitization, many other new products and services that promote economic growth and serve consumers, and do so with effective safety and soundness supervision and meaningful capital.

I believe that this will promote homeownership if applied to Fannie and Freddie. Indeed, I think effective supervision and meaningful capital will reduce the cost of homeownership if investors, particularly bondholders in Fannie and Freddie, have confidence in the regulator and believe that meaningful capital is a discipline on risk-taking. And if they have enough information on which to base informed decisions, Fannie's and Freddie's cost of funding will drop and that should be translated into reduced homeownership costs, especially for the minority and low-income customers for whom the benefits of the GSEs were initially intended. The three tenets of effective bank supervision as established by the Basel Committee and adopted by all of the U.S. bank regulators, the Fed, the OCC, the FDIC and Office of Thrift Supervision, are first, capital; second, supervision; and third, disclosure. I suggest that as you look at the system for Fannie and Freddie, you keep those principles in mind and ensure that the new regulator you establish has ample authority to ensure that all three of those pillars are strong and lasting.

The 1992 regulatory structure established at that time for Fannie and Freddie, who were then one-third the size they are now, taking very different risks than the ones they take now. I must say, I view that as a divide and conquer structure which would have had a difficult time working under any circumstance. If it ever could have worked, it certainly has not. The news we have had from the markets of late, especially that related to the Freddie Mac restatement, and again the news this morning as more information was released by Freddie Mac as to how it sees its balance sheet and its earnings going forward, are deeply troubling.

The role of OFHEO as the safety and soundness regulator, not only in anticipating, but fundamentally a safety and soundness regulator should prevent these types of risk. We have seen no signs, for example, that OFHEO has undertaken the reviews of internal audits, of management and of controls at Fannie and Freddie that the bank regulators have rightly undertaken in the wake of the Enron case and of Sarbanes-Oxley.

Secondly, the regulatory capital rules need significant fixing. OFHEO's standards, complex to be sure, are vastly different than the rules the bank regulators now employ and the rules pending in the Basel Committee for all large financial services firms. They are premised on derivatives. Mr. Frank mentioned earlier his concern about these. I think it is important to note that the OFHEO risk-based capital rules allows Fannie and Freddie to count hedges as if they were real shareholder capital. They are not and they should not be permitted going forward. Effective supervision requires an independent agency and I think safety and soundness supervision means new program control. Often the riskiest things an institution does are its newest. Safety and soundness supervision there is essential.

Finally, good disclosure, a real stand-alone rating, and SEC registration, and I think call reports comparable to those used by banks.

Thank you very much.

[The prepared statement of Karen Shaw Petrou can be found on page 78 in the appendix.]

Chairman BAKER. Thank you, Ms. Petrou.

I would like to note that your observation with regard to the Basel Accord, capital supervision and disclosure are exactly the principles around which we have tried to construct the regulatory reform recommendation. Importantly from strategy, some have questioned why have we moved so quickly. It was to frankly get the bill into the public domain so that markets could respond, and through this morning, the comment has been very favorable and already begun to have some positive impact on market pricing for GSEs's capital.

I was very troubled in understanding your testimony. I now know that Freddie has announced that it cannot under GAP standards treat any of its derivatives in portfolio as GAP-qualified accounting hedges. You made the comment that then these hedges could not then count as capital or shareholder equity. What I am troubled by, or ask your opinion on, does the rules-based capital test that OFHEO now utilizes permit these derivatives that are not now GAP-compliant still to be counted as capital?

Ms. PETROU. Yes, sir. It is my understanding that it does.

Chairman BAKER. What possible relevance could the stress test then have to properly assessing the capital adequacy of the enterprises?

Ms. PETROU. I do not know.

Chairman BAKER. I understand, too, that Freddie now is having to basically take back credit risk as a result of implicit recourse, because it was basically backing its own credit risk instead of having laid off that risk to third parties. If that is correct, and I am making an assumption, how can that be consistent with its own charter obligations?

Ms. PETROU. I do not know, sir. The charter requires all of the GSEs to hand-off the risk of high-risk mortgages, those with loan-to-value ratios above 80 percent, to qualified third parties, generally mortgage insurers. It is unclear from the results this morning the degree to which that in fact was done.

Chairman BAKER. So could that possibly be, in your opinion, a violation of the charter?

Ms. PETROU. The facts will need to be carefully examined, but it is certainly possible.

Chairman BAKER. What about Freddie eliminating its held-to-maturity book? And what implications does that have on Fannie Mae, if any?

Ms. PETROU. Again, it remains to be seen. This gets to the very complicated question of the relationship between FAS 133 and how assets are valued on the balance sheet and which assets are marked to market and which ones are not. Freddie Mac this morning reported that its investigation to date found that assets were held to maturity that were in fact being traded or sold. It is again somewhat still unclear what actually was going on.

Chairman BAKER. So there apparently were assets being held to maturity while being available for sale?

Ms. PETROU. That is correct. And the accounting rules require that once that finding has been made, the entire pool of held-to-maturity assets is, if you will, tainted. So now everything has had to be moved over to available for sale.

Chairman BAKER. Let me ask each of you. I know that some have suggested that we go further with our regulatory reform. Are there any of you who have any objection to any particular portion of H.R. 2575 in the time you have had to review it, understandably being short? Are there portions of it which you have concerns may adversely affect the functions of either GSE as proposed? Anybody?

Ms. PETROU. I would say, sir, that I think that making HUD the regulator for new programs is something at which I would suggest you take another look. It has had that authority for 10 years. To my knowledge, it has only acted on one new program and that was at the direct request of Mr. Leach, going back to 1997 when one of the GSEs decided to enter an aspect of the life insurance industry, and then HUD approved it. It does not have a good record here, nor does it have the skills to be a safety and soundness analyst of new programs.

Chairman BAKER. One further question before my time expires. It appears, and I am only acting now on a quick read of the morning news with regard to Freddie's most recent disclosure, that they are acknowledging that they did not have sufficient resources or personnel to sufficiently gauge and manage their derivatives risk portfolio. It might even be broader with regard to internal operational risk management functions. If that is the corporation's position, how is it possible, given the resources that Freddie does have available to it for risk management purposes, that we could view OFHEO by contrast in any credible light, not because of the quality of individuals, but because of the limitations of funding and simple numbers of personnel? Is that a fair comparison to make?

Mr. SCHATZ. Mr. Chairman, if I may, I would agree with that. It is one of the reasons why we support your efforts to move the regulatory authority over to the Department of Treasury. These are large financial institutions that engage in very complex financial transactions. Certainly they are still achieving the goal of providing greater homeownership for the American people, but certainly given the developments and the changes in what they are now engaged with compared to 10 or 15 years ago, Treasury is the only place where that expertise would reside. I would agree with Ms. Petrou's remarks about the safety and soundness, as well as new program authority, really being together as opposed to being separate.

Chairman BAKER. Thank you. My time has expired, but I have just got to make a comment. If the facts presented this morning are accurate, and I presume that they are and we will take time to examine it and understand it more fully, I cannot comprehend how anyone could go home feeling confident that the current regulatory structure is in any way adequate in light of the risk that has been published to date.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

We seem to be moving ahead, and most recently we may have made the error in military policy on everyone concluding on everyone else's statements or news reports that there is incontrovertible evidence of weapons of mass destruction. It seems that term was thrown out there, everyone accepted it, and accordingly policy was made, no one testing the basic premise. Does anyone on the panel today, can they tell us actually what happened at Freddie Mac? In fact, is there a serious violation of law?

Mr. COCHRAN. Mr. Kanjorski, not having published their financial statements for 2002, I can't make that statement. I have not been able to look at them yet.

Mr. KANJORSKI. I haven't either, and that is why I am wondering whether or not we shouldn't first have a premise of what happened down there, instead of deciding that clearly what happened down there warrants significant substantive change. I am not opposed to change, and certainly in my opening statement I recommend and have been recommending for years certain things that I hear the panel agreeing with, the fact that we should have an independent regulator; that we should have an independent regulator with the same authority that other regulators of financial institutions have, which OFHEO has never been given; that it should not be funded by annual appropriations at a very meager amount, but should be self-financing through assessments on the bodies being regulated. We all agree on those principles, right?

I think we could very easily move forward, whether we call it modernization or reform or anything else. I think it would be something we could all agree on to do that for the regulator of the GSEs. But some of the things I fall out of favor with, or have not certainly been convinced, to taking a retail regulator like the Office of Thrift Supervision has the expertise to handle a very sophisticated, two or three sophisticated entities such as the GSEs. Do you really all believe that compared to all the regulators that exist in the financial institutions of the United States, the Office of Thrift Supervision is going to be the best regulator we could select? What is your opinion on that?

Ms. PETROU. I would agree with that concern, sir. It would be within Treasury and it does have resources, but it also has many distractions.

Mr. KANJORSKI. Right.

Mr. EGAN. I would like to comment on your previous question, and that is the accounting discrepancies and the dismissal of the executives. From our perspective, that is a secondary issue. The primary issue with the GSEs is their level of capitalization. The accounting revelations were really just an accident waiting to happen because they have relatively little cushion in their capital base, number one; and number two, that rating of AAA is unrealistic unless you assume that the line of credit from the Treasury is significantly greater than $2.25 billion. If somebody told us it is closer to $60 billion per institution, then we move above the single A level, but we have heard nothing of the sort.

Mr. KANJORSKI. So the underlying premise for this hearing, the recent news releases and the firings at Freddie Mac precipitated this hearing, but you are telling me they are not the basis on which this committee should be looking at new regulation. There are some other substantive questions.

Mr. EGAN. They run much deeper than that.

Mr. KANJORSKI. Right. I agree with you. We have been carrying on our examination for more than 40 months and have been making some progress, sometimes by voluntary disclosure and transparency that the two organizations have had.

I tend to worry about our establishing some precedent for action based on incomplete news reports and internal actions by the board of directors. Quite frankly, I could understand a board of directors being annoyed with a set of management that have not complied with making restatements in a number of years and just getting totally fed up and saying enough is enough and you are gone. We are going to put somebody else in. It should not necessarily connote to the market or to anyone else that there was something criminal or improper that was carried out. It was just probably a great frustration or could have been a great frustration of the board, and a very responsible act by the board, I may say, if that is the derivation for the action. Would you agree?

Mr. EGAN. Yes, but I would characterize it as saying these are two critical institutions and that investors are confused right now. They are concerned when they see executives resign. They are concerned when they hear about accounting problems, and they are concerned about the regulatory environment of both GSEs. I think it requires a closer look at the entities and how they are regulated, and whether or not investors are investing on an appropriate basis, or whether another signal has to be sent to the market.

There is also the issue of whether or not they lose their AAA rating; whether or not they still can exist in their current form. My understanding is that they are not putting up much capital for their derivatives. In fact, in a lot of cases they are putting up no capital because of that AAA rating. If that goes, a question is how badly the institutions will be hurt. So it is a very broad question that I think needs to be addressed. Whether or not it ends up that you move it to a different regulator is part of that broad question.

Mr. KANJORSKI. Should we as a committee be acting just perhaps a little more responsibly in finding our what happened and starting from the core of the facts of the information before we move? I heard so much of your testimony, "if this happened, if this happened, this may have happened, this could be." But no substantial statement of facts as to what did happen, and yet we are speaking to the world market here in a way that could be very crucial at a very delicate time in our economic structure as a whole. I am just wondering just how responsible it is for us to conjecture as to what may have happened and talk about it as if it in fact did happen. Not that we should wait, but I am surprised that maybe some of our first witnesses are not the regulators, and aren't some of the officials that made the decisions within Freddie Mac to tell us what they did and why they did it.

Mr. CASTLE. [Presiding.] If you could answer briefly, we need to move on to other witnesses please.

Mr. EGAN. Very quickly, from our perspective, the current regulator should not have allowed the capital to dwindle to the point that it is as a percentage of assets. That is a fundamental issue and investors are still thinking it is a AAA rating and hopefully it can be handled delicately so it does not cause a panic in the market.

Ms. PETROU. If I could also just add, one thing we do know, we don't have any ifs about, is what OFHEO has done through this process. When Freddie Mac first announced its restatement in January, within hours the head of OFHEO said he saw no problems. Consistently as each revelation has come out, OFHEO within hours has commented on it. Bank regulators never talk about their charges because they believe in something they call constructive ambiguity. That promotes market discipline and it is essential. We do know that, sir.

Mr. CASTLE. Thank you, Mr. Kanjorski.

Mr. Ney is recognized for 5 minutes.

Mr. NEY. Thank you, Mr. Chairman.

The current regulatory regime for the GSEs has a product review on safety and soundness regulator split between HUD and OFHEO. The new proposal keeps that system with HUD regulating new products and the OTS regulating safety and soundness. I am wondering if keeping this system is in the best interests of the GSE regulation because they could be rather intertwined. So would it make sense or wouldn't it to centralize all the GSE regulations under one roof or not? Anybody that would like to answer.

Mr. SCHATZ. Mr. Ney, we have made that proposal and we certainly urge the subcommittee to examine it, discuss it with the regulators, and determine whether this would be best, and also look at how other financial institutions are regulated to determine whether there is a bifurcated system out there or a single system. It seems to me that there is more or less a single system for soundness and safety. The new program authority is certainly unique to the GSEs in some ways, and I would hope that as the subcommittee moves forward and the full committee moves forward that you do discuss this in some depth.

It is our view that the new programs, if they are not tied to safety and soundness and the same regulator is not aware of what the GSEs are supposed to be doing in their mission, that is one of the problems that could occur. There was a statement earlier about the fact that OFHEO in its 10 years only interrupted or said that it was not going to support one particular product indicates that they are not doing a very good job of making these determinations. I am sure there are other products that may have been reviewed or reviewed differently if they had been more aware, or certainly tied into more knowledge of the financial system that the GSEs are involved with as well.

Mr. NEY. So you approve consolidating them?

Mr. SCHATZ. Yes, we would approve consolidation. But again, I think you would need to compare this to the other financial institutions in the country as well, to be consistent.

Mr. NEY. Does the rest of the panel agree with that or disagree?

Ms. PETROU. I would agree with that, sir.

Mr. EGAN. Our view is whoever regulates them has to have in-depth knowledge of the financial market, hedges and be able to stress test assets and liabilities and really have a very sophisticated banking examiner.

Mr. COCHRAN. You might pose the question oppositely and ask, if you keep it bifurcated like it is now, what happens if those two regulatory aspects come into conflict? Who dominates, safety and soundness or mission? So there is probably a rationale for keeping them consolidated under one regulatory roof, so to speak.

Mr. NEY. Do you have any comments on the prior approval that would be in the new piece of legislation?

Ms. PETROU. You are referring to the prior approval of new activities?

Mr. NEY. Of new product. Is it enough? Does it overregulate?

Ms. PETROU. Right now, all of the insured depositories and their holding companies need prior approval from their safety and soundness regulator for any new activity. Yet we have an industry that is by far the leader in the world in innovation. I think it is important because it protects safety and soundness. It also protects consumers. In new products there are potential abuses, conflicts of interest, disclosure issues. Prior review by a skilled regulator is really essential.

Mr. NEY. So you say it is common for every single product or change in existing product in all cases to have prior approval?

Ms. PETROU. All new products which raise significant issues. Congress has rightly put in place a system for traditional products at traditional institutions of notice to the supervisor, but those are still all done in a public process. Any significant new activity must be reviewed by the regulator and put out for comment so that all appropriate views are considered before the deposit insurance funds or the lender of last resort is put at risk through a potential new activity.

Mr. NEY. Over the years, the OTS has developed a lot of expertise in regulating thrifts and the unique business model that comes along with thrifts. Any thoughts about taking OTS into a whole new different regulatory venture?

Ms. PETROU. I think it raises significant issues because we have "housing finance" here, but Fannie and Freddie are so huge and their hedging activities are so different that they could be considered housing, financial institutions or even hedge funds, and a supervisor with the skills to do both is essential.

Mr. NEY. So you feel the OTS has been towards, again, thrifts and the unique situation there. But you feel comfortable that OTS could undertake this and be able to do this with Fannie and Freddie?

Ms. PETROU. No, sir. I have some questions about that.

Mr. EGAN. I agree. From our perspective, the hedging operation is like the nitroglycerin of these companies. It has to be handled very careful, made sure it is set up properly, that it is matching their asset and liability structure. It has to be reviewed properly. The counter-parties have to be understood. It is far beyond the normal thrift institution. It is more akin to regulating CitiGroup or J.P. Morgan or some of the investment banks.

Mr. NEY. Thank you. My time has expired. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Ney.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

I am very, very much concerned that we do move forward; that we work very judiciously on this issue. I certainly appreciate the chairman allowing me an opportunity to work with him on this legislation as we move forward.

I do think we need to move with a bit of caution because the first question I want to ask is, what impact would our proposed legislation in this committee to strengthen the regulatory oversight have on the stated mission of these two entities? It is my understanding that stated mission is to buy home loans from banks and lenders, to supply ready cash to the home mortgage market, especially for middle-income and lower-income individuals. Given that, and I don't know which of you might want to respond, Ms. Petrou, I certainly want to get your opinion on that question, what impact would it have? I think that is a fundamental issue here as we move forward, because Fannie Mae and Freddie Mac were created for a special purpose.

The other part of this question is that it is very complex and complicated, but from what I am following here, the nut of this issue it seems to me is this business of derivatives, which are used to hedge interest rate risk. Now, if I am not mistaken, derivatives was the key role that was played in the Enron upheaval. So I would like to get an analysis from you of the derivatives in relationship to this question. If we are using these derivatives, if we are using them to hedge on this risk-taking of interest rates and it resulted like Enron, the fundamental question then becomes, is Fannie Mae and Freddie Mac taking on too much risk?

If you could answer those for me, and I do have one other point I want to get to later, so Mr. Chairman, please, if they talk too long or I talk too long, please correct me because I would like to ask another question. But I would like to get an answer on that one, please.

Ms. PETROU. First with regard to the mission, sir, I think that appropriate regulation will enhance, advance and reinforce that mission. One provision in the Chairman's bill addresses HUD's role in ensuring that Fannie and Freddie serve affordable housing. In my opinion to date, the goals have been too lax; the definition of affordable housing too generous; and the enforcement nonexistent. We have had a lot of rhetoric, but we need an effective supervisor to ensure real performance, just as we have bank regulators who look in and enforce in cases where financial services firms, especially insured depositories, are not doing right by their low-and moderate-income customers.

Mr. SCOTT. So you think that moving the regulatory oversight to the Treasury Department would help the mission?

Ms. PETROU. Yes, sir. I know there is some issue as to whether or not Treasury is as devoted to homeownership as it is perhaps to safety and soundness and stable financial markets, but I think with the role of HUD and of course with congressional supervision and clear direction to Treasury, you can ensure that a new regulator takes as full account of those responsibilities as the bank regulators do. For example, you have told them to have a Community Reinvestment Act and that has helped bank regulators govern their charges, and you can do the same for Fannie and Freddie.

Mr. SCOTT. What about the idea of registration of debt with the Securities and Exchange Commission?

Ms. PETROU. I would support that.

Mr. SCOTT. You don't feel that would hamper the mission?

Ms. PETROU. No, sir. I think it might help in fact to improve it by improving investor understanding, reducing costs. Fannie's and Freddie's costs of funding could well diminish. Indeed, Moody's recently suggested that it would and that is what the GSEs should be passing on to the neediest homeowners.

Mr. SCOTT. The other question I wanted to ask is, just for the record, do you believe that because of the similarities between Freddie Mac and Fannie Mae that Fannie Mae may be being tarred by the same brush? Do you think it is fair to judge Fannie Mae based upon the missteps of Freddie Mac?

Ms. PETROU. I don't, sir, at this point, but I do think it is fair to say that both GSEs operate under divided and in many respects faulty regulation with inadequate capital and lack of appropriate market discipline.

Mr. SCOTT. Okay. My final point, Mr. Chairman, the Office of Federal Housing and Enterprise Oversight has got 140 staff and a $30 million budget. Do you think that is enough? Do you think they are too weak to perform the task? That they need to be strengthened in terms of manpower and budget?

Mr. EGAN. Our view is that it goes beyond even the regulatory environment; that there are some problems in the market itself that have gotten us to this point. There are problems with the investment banks, all the analyst came out positive, I think, about 10 analysts came out positive, one came out negative after the disclosures on the accounting issues. That is a structural problem. The fact that the major rating firms are all paid by the issuers and get the bulk of their compensation from these major issuers, that is a problem. Regulation has typically lagged.

It would be terrific if you set up a huge regulatory body, maybe you would get better disclosure, but it has to go beyond just that issue if you are going to protect these firms in the future and protect investors. The worst that could happen, they are doing great work, the worst that can happen is that there is a breakdown in the market and investors lose faith. The investors think that the U.S. government is behind this whole thing 100 percent. That is why there is a AAA rating. This whole area has to be addressed and the structural problems in the financial markets have to be addressed.

Mr. SCOTT. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Castle?

Mr. CASTLE. Thank you, Mr. Chairman.

Let me just say to you first of all, you have wandered in the desert for some time and I think you have found your oasis, and I think the rest of us had better start paying some attention to this. This is not something that is easily understood or can be swept under the rug, in my judgment. Let me thank the witnesses for the tutorial today, because I am still trying to define the problem. I haven't even gotten to whether there is a solution at this stage.

Along those lines, if I could just ask you some consumer-type questions. I want to know what is at risk here. For example, the housing market has been the strongest part of our economy for the last 3 or 4 years. I just refinanced my mortgage. I am pleased with that. Actually, it is not complete yet; hopefully it will go through. Obviously, Fannie Mae and Freddie Mac are tremendously helpful with that, based on all that I read and understand, although I could not tell you why, but that is what they tell me.

My concern is, are we by taking the actions that we might take here, are we going to disrupt the housing market in some way or another, or the securities market, or even the stock market in terms of the stock values of these companies? In other words, by dealing with the additional regulation, is it going to be such a great burden or such a great shift that there is going to be tremendous impact out there? On the other hand, if we don't do it, is there going to be potentially an impact? I can't really honestly define everything that went wrong with Freddie Mac or whether Fannie Mae has any problems or not, but my sense is that they are less regulated than a lot of other financial entities, and that is potentially a problem as well.

So if you could just, if any one of you or two of you or whatever, can help me with understanding the potential problem a little more in terms of what could happen here, I would appreciate it.

Mr. SCHATZ. I just wanted to just jump in a little bit, Mr. Castle. The problem really will arise if Congress does nothing. After the Enron scandal and Arthur Anderson, certainly steps were taken to strengthen regulation over the accounting profession and the securities and others. Here we have two large organizations that are exempt from many of the laws that apply to their competitors, to every other publicly traded company. Our view is that placing them under the scheme would reassure investors, reassure the public. They would certainly still be able to compete and compete very well, as they do, in the marketplace, and that it would restore a great deal of confidence that may have been shattered not by what you are doing, but what happened at Freddie Mac.

So it is in a sense a problem of their own making, but it does draw more attention to what the chairman and others, and Mr. Shays and others have been talking about for some time, which is simply trying to improve regulation and oversight. No one is talking about putting them out of business. We are talking about providing a structure that will give all these people, the shareholders, the taxpayers, consumers, the banking system, the housing system, more confidence that oversight is being exercised in an appropriate manner.

Mr. CASTLE. Thank you.

Mr. EGAN. Our view is along the lines of a stitch in time saves nine. If you don't act, this is probably what is going to happen, that Fannie Mae's capital base instead of dropping from 3.1 to basically 2, in another 2 years it will probably be about 1.5, and just keep dropping from there. There is huge pressure on these organizations to grow, so you have to hold them back, no constraints.

What would be an ideal world is if there is a new regulatory body. It had some real powers. It encourages these organizations to strengthen their capital base.

Mr. CASTLE. Excuse me. Let me interrupt there, because I wanted to ask this question anyhow. By a new regulatory structure, you are suggesting that OFHEO just is not capable of being structured in such a way that it could carry this out responsibly?

Mr. EGAN. We have not seen any evidence of that, and hopefully it won't come to that to encourage some discipline in the rating agency industry also, and some discipline with the equity analysts. Obviously there are still some problems. What would also help is that if you had some new mortgaged-backed agencies, some mini-Freddie Macs and Fannie Maes that are growing, so if God forbid, anything happened to these two entities, that we are not just counting on them; that we have some alternatives, some viable alternatives, in the market. If we could achieve that goal in another two years, it would be a huge positive to the people holding the mortgages, the homeowners, the markets, everybody would benefit. On the current path, it is just a problem, a sore, that is going to continue to fester and grow.

Mr. CASTLE. Should the Federal Home Loan Banks be considered or included in any legislation that we do?

Mr. EGAN. I am going to defer to some other panelist.

Ms. PETROU. I think there are some significant supervisory issues there that do warrant your review. The Federal Housing Finance Board in only the last year has taken a look and found that it had three times more PR people than it had examiners. That is for an institution which in aggregate is about $800 billion. So I think a hard look does need to be paid.

Mr. CASTLE. Thank you, Mr. Chairman. I yield back.

Chairman BAKER. Thank you, Mr. Castle.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

I am just trying to understand what is the bad thing that can happen here? Mr. Egan, you said things happen, and yes I know exactly what your teenage son would have said instead of that. And I know that by saying "things happen," you intended some ambiguity that we can't possibly anticipate all the bad events. But it seems to me that the thing that these two institutions have going for them is that ultimately they rely upon what is for most households the ace of trumps, the mortgage. People may or may not pay their credit card bills, but they sure pay their mortgage.

It certainly seems like Fannie Mae and Freddie Mac should not have to have the same kind of equity requirements that, say, MBNA has. What can cause the meltdown here? Is it that people don't pay their mortgage? Is that there are fluctuations in interest rates? Is it the ways that interest rate fluctuations are hedged is somehow risky in a way that is incomprehensible to 99.95 percent of the population in this room?

Mr. EGAN. There are a variety of things that could happen, and you could assess some probability of that happening. Unless the economic environment changes drastically, probably the mortgage payment rates are not going to change very much. What is probably going to be a bigger problem is that there will be some revelations that over the next six or twelve months that both these entities are having difficulty. Because Mr. Castle prepaid his mortgage perhaps yielding 7.5 or 8 percent, and now is only paying 5 percent.

These entities receive that money and now can only reinvest it in the market at 5 percent. However, on the liability side, because they can't pay off all those liabilities, they still have to pay 5.5 or 6 percent. That is a problem. These are huge entities so it is difficult to hedge completely against that problem. Maybe they have to revalue the portfolio because they have to mark-to-market because they sold out some of the instrument, and that 1.9 percent capital goes down to 1.5 percent. Maybe it is that our competitors S&P and Moody's realize that maybe this really isn't AAA and they do some investigation and realize the capital line is only $2.25 billion, and no more after that, and therefore they reassess their position and all of a sudden it slips down to AA, and some major investor groups, the Japanese or the Germans, pull out their capital or reassess their investment.

It is an accident to have so much water behind the dams, is a nice way of thinking about this. These institutions were built to hold so much water and there is too much water behind it. You need to let down the water level. You have to shore up the dam so that it is safer, and hopefully get some other dams in place, too, so that you are not dependent on this one river system. So there are a variety of different problems that could happen. It is hard to figure out which one exactly is going to hit, but certainly you don't have the cushion that you should have.

Mr. MILLER OF NORTH CAROLINA. If we take less water behind the dam, if we let down the water level, are we not inevitably going to make mortgages less readily available?

Mr. EGAN. No, because the markets are fluid and hopefully there will be some other institutions that will be encouraged to step up their activities. The other approach is just continuing to build it up and I would argue that you don't have enough cushion right now to continue to let it happen, and the forces are in place that if it is not pulled back, the asset base will continue to grow.

Ms. PETROU. I would say, sir, also that when you describe mortgage credit risk, which is all of our desires to pay our mortgages off first, that is the risk Fannie and Freddie were established and chartered to take for the lowest-risk mortgages. What they were supposed to do when Congress established them was to buy mortgages originated by lenders, turn them into mortgage-backed securities so the investor would take all of that interest rate risk that Mr. Egan described. Fannie and Freddie would hand-off the riskiest pieces of the mortgage credit risk position to third parties, and they would then hold the rest, the safest piece of that mortgage credit risk. That is not how they are structured any longer.

Chairman BAKER. I thank the gentleman.

Mr. Shays, you are next. And just by way of comment on the last exchange, the last quarter of 2002 there were reported negative duration gap difficulties for Fannie Mae which is a reflection of the mismatch in their portfolio because of the extraordinarily low-cost interest rates for so long. The solution or remedy as I understand it was to merely acquire mortgages and grow the portfolio, which does not necessarily yield any more profitability, but does increase risk to the taxpayers.

And by the way, Mr. Shays, you are recognized.

Mr. SHAYS. Thank you, Mr. Chairman.

You have the second and fourth largest financial institutions in the United States. You have the 16th and 32nd largest Fortune 500 companies. Under the law, they were not under the 1933 and 1934 Security Acts. Neither of these Acts were to punish companies, correct? What are the purposes of both of these Acts?

Ms. PETROU. To protect investors by informing them of a wide range of financial information and to give remedies when these protections are not in place.

Mr. SHAYS. And we require all Fortune 500 companies to be under these requirements. Is that correct?

Ms. PETROU. All publicly traded firms.

Mr. SHAYS. All publicly traded. So if that is the purpose, then explain to me how putting them under the Act harms these companies or harms these investors? I am at a loss of words to understand how anyone can say putting them under the 1933 and 1934 Acts somehow is going to harm them and harm our economy. Please tell me how.

Mr. COCHRAN. I think the claim that is being asserted is that by coming under the Act, they will have to register and incur the costs of registration, and that cost flows to the bottom line.

Mr. SHAYS. So it is the cost issue.

Mr. COCHRAN. That would be my estimate.

Mr. SHAYS. Right. And so what we did in our legislation, we capped them to say they would have to contribute no more than 5 percent of the total amount to the SEC, and any other company. Wouldn't that minimize that issue?

Mr. COCHRAN. It probably would. And by the way, I do not necessarily agree with that assertion in any case.

Mr. SHAYS. Okay. Does anyone agree with that claim that it is going to hurt them? Okay.

Let me understand Freddie's statement today about what they are disclosing. Would someone here tell me what you think Freddie said today about the fact that they have to re-state earnings. What is your sense? Tell me what you think is going on at Freddie in short-term, not a long sentence. Sean, do you want to do that?

Mr. EGAN. That they are still getting a handle on exactly what is going on; what their derivative positions are; how to value the securities. They are hoping they get it right this time, but they are not quite sure and hopefully they don't roil the markets too much.

Mr. SHAYS. Anybody else want to add something?

Ms. PETROU. No, we heard this morning was that the earnings range now will be increases of between $1.5 billion and $4.5 billion, and that the bulk of this is resulting from significant new disciplines related to derivatives.

Mr. SHAYS. My understanding is they said they didn't follow general accounting practices or what would have been required under the SEC, and had they followed what would be required under the SEC, they wouldn't be in this problem. Is that true?

Ms. PETROU. It is unclear whether they would have been in this problem because firms under the SEC, of course, have also encountered serious issues. But I think there are questions.

Mr. SHAYS. Let me put it differently. If they followed the requirements under the SEC, they would have not have encountered this.

Ms. PETROU. This morning Freddie Mac indicated there were aspects of the restatement that might violate securities law had they been subject to them. That is all I can speak to. That is one of the pieces in their release this morning.

Mr. SHAYS. Would you explain to me when they say that their earnings were understated, is that a good thing? Should I feel comfortable that there is potentially $4 billion of understated earnings in the past? Like, in other words, they have more earnings. Does that mean, one, they didn't pay proper taxes in the past? And two, should I say this is good news?

Mr. COCHRAN. I think as Congressman Frank suggested, there are ways to interpret the application of accounting rules. But I think what concerns the markets is that by restating the earnings, you are going to increase the volatility or the variance in the reported earnings. Other things being equal, we would rather see smooth earnings over time, rather than bumpy earnings.

Mr. SHAYS. So investors would rather see constant growth, not really terrific years and bad years. And so if Fannie or Freddie experiences that kind of growth pattern, how does the investor respond to it?

Mr. EGAN. From our perspective, it is unsettling. It is unsettling because there is a lot more volatility in the earnings than what they would like to have been the case. They are trying to smooth earnings and now they found out that they can't, and the investors are thinking it is not quite up to the AAA rating that it should be.

Mr. SHAYS. Okay. Just one last question, Mr. Chairman? So if I am an investor, I should not say this is good news that they had really higher earnings in the past which they understated.

Mr. EGAN. No, because it is going to be depressed in the future. It is just taking earnings that they are pushing out in the prior years and they won't have it in the future years. It just means that the volatility will be greater. It is not comforting.

Mr. SHAYS. Okay. Thank you, Mr. Chairman. Thank you to the panel.

Chairman BAKER. Thank you, Mr. Shays.

Mr. Clay?

Mr. CLAY. Thank you, Mr. Chairman. I want to thank the panel for their testimony today.

First, a few observations in regard to this legislation and the subject matter. I think we must identify the level of mismanagement, be it accounting problems or criminal activity. Solutions for Freddie Mac must be based somewhat on those answers. Are we going too fast without knowing what we are correcting? Or are we negatively affecting the markets with this rush to judgment? Hopefully these hearings will bear that out.

Let me ask about the proposed bill which imposes restrictions on non-mission-related investment by Fannie Mae and Freddie Mac. My understanding is that the non-markets investment portfolio is used as an essential risk-management tool. These liquid investment portfolios serve as a capital cushion used by the companies to manage liquidity needs. By restricting this risk-management too, the bill takes away Fannie Mae's and Freddie Mac's ability to manage a liquidity crisis like the one the country experienced in the fall of 1998. Because of the current structure, Fannie Mae and Freddie Mac were able to step up in a turbulent time and provided stability in the United States housing markets. Why do you think this tool should be eliminated? We can start with you, Mr. Egan.

Mr. EGAN. I don't think it should be eliminated. I think it has to be properly managed or you run the risk of losing the tool, so to speak. These are great institutions. They have created a huge amount of good for a number of people. The risk is that they are not regulated properly; that they are misperceived in the market; that if the problem is not addressed in the near future, that you cut off access to mortgage funding for a lot of people. So our view is that it just has to be managed properly and hopefully some other institutions will grow to compete with these two. It is a very important area and it is unwise to leave just two major institutions fulfilling this function.

Mr. CLAY. I heard you say that before, too. Now, do you think that other institutions will step up and follow the mission statement of these two entities, I mean to really go after the low-and moderate-income individuals who have that desire to realize the American dream?

Mr. EGAN. Yes, because there is a profit incentive. The institutions have outgrown their $2.2 billion capital line. Other institutions can be set up to serve that area. So yes, I think that other institutions will fill the void.

Mr. CLAY. Let me ask you, based on an open-ended public interest standard, this new regulator that is proposed in the legislation could make public any information about Fannie Mae or Freddie Mac. Doesn't this bill throw overboard any notion of safeguarding proprietary corporate data or examination confidentiality? Wouldn't one impact be to make all corporate data potentially available to competitors? Anybody can tackle it.

Mr. SCHATZ. Mr. Clay, I would expect that as the subcommittee and full committee review the specific provisions of the bill that it would protect any proprietary information for Fannie Mae and Freddie Mac as it would any other company. I would hope that would be the ultimate outcome of that particular piece of legislation. No one is intending that their proprietary information be made public. That does not happen in other circumstances and it would not be appropriate here.

Mr. CLAY. Would that really put those two entities at a disadvantage, those GSEs at a disadvantage?

Mr. SCHATZ. Again, I have not examined every single word, but it seems to me that whatever bill comes out of the committee would simply not do that.

Mr. CLAY. Okay.

Mr. EGAN. A good measure of whether or not they have anything proprietary is whether or not they have a number of their officers sign confidentiality agreements pertaining to the software they use for managing derivatives and things of that nature. It would be surprising if they have that much proprietary information.

Mr. CLAY. Okay. From what I understand, developing a new product can take a lot of time, money and resources. When Fannie Mae or Freddie Mac make this effort and start to work with a group of pilot lenders, sometimes they are not sure whether the new idea will appeal to consumers. Why would the GSEs and lenders advance so much effort into product development if there is a greater fear and chance that a regulator would turn it down?

Ms. PETROU. That is the same risk that, of course, Congress has asked all the nation's banks, savings associations and financial holding companies to take because that investment is backed by the taxpayer. Programs can look little. There is one right out there now which is described as a pilot that Fannie is working with some lenders to offer in 50 percent of the nation's mortgage markets. That is really I think a form of consumer lending. So prior approval which bank regulators are good at and banks are good at filing all those applications has never been an impediment to innovation and I don't think it would be for Fannie or Freddie either.

Mr. CLAY. I thank the panel for their answers.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Clay.

Mr. Baca?

Mr. BACA. Thank you very much, Mr. Chairman.

First of all, let me thank the panelists for appearing here today. I have a couple of concerns that I would like to express, but before I do, I would like to recognize the work that Fannie Mae and Freddie Mac have both done. They have served an important role particularly for the Hispanic and minority community. Both companies have a very good track record of expanding minority homeownership. Hispanic ownership rates have increased from 44.7 percent in 1998 to 48.2 percent in the year 2002. In the year 2002, more than half of Fannie Mae's business served low-income and moderate-income families. And Freddie Mac also financed over $135 billion in loans to almost one million minority families in the year 2002. Finally, Fannie Mae has also created the American dream commitment to provide $2 trillion in financing in serving 18 million families by the end of the decade. I am very much concerned about the effects that this legislation is going to have. My question would be, what information can you provide me to show that Hispanics and other minority communities will not be hurt by some of the proposals that we are hearing here today? That is question number one. And two, in particular, what effect would change in the oversight from HUD to the Treasury Department have? That is question number two. And is the regulation necessary to avoid more corporate scandals? That is the third question.

Any of the panelists like to tackle this? I heard Karen mention we are too generous. What does that mean? For whom or what? And what effects then will it have on minorities now who have the first opportunities to own a home? They never had it. Are we going to change it?

Ms. PETROU. I don't think I said that any public policy was too generous to low-income and minority homeowners. That is the most struggling part of the market and it is really where the $13 billion of subsidies provided on an annual basis to all of the housing GSEs should be directed. What I tried to suggest and I think there is some significant research out there that I would be happy to submit for the record, is that good regulation would reduce the funding costs of the GSEs and that would make it easier for them to reduce homeownership costs, particularly at the most struggling ends of the market.

Mr. BACA. What effects would it then have on minorities or Hispanics on homeownership?

Ms. PETROU. I think it would result in increased homeownership. For example, if you look around many areas of the cities, the District of Columbia is the one with which I am the most familiar, aspects of the market or access knowledge, language barriers, and that is very costly. I think helping the GSEs reduce their cost of operations would permit more of those funds to translate into Hispanic homeownership.

Mr. BACA. What outreach or programs would be available to make sure that was done? You can have the regulations, but if you don't have the outreach into the minority communities or others to what is available, and what Fannie Mae and Freddie Mac are doing is that they are doing that. The educational programs, then, would not be effective.

Ms. PETROU. That is what a good regulator is for, to say here is what you do and to be sure that is what they are doing.

Mr. BACA. It doesn't happen all the time, though. Can somebody else answer the additional questions that I asked?

Mr. EGAN. Our perception is that the market does not give gifts. That is that minority homeownership has increased dramatically because it has become easier in the market to afford the mortgage. Interest rates have dropped to record low levels. Hopefully, these two GSEs will continue their good work and the levels that they have in the past, and hopefully they can get some more capital. But don't confuse the record number of homeownership with their growing very rapidly. It is broader than that. It is really a function of decent economic times overall and the record drop in interest rates.

Mr. BACA. Right. Well, that is why I am concerned a little bit with the proposal because when you open the market, then you target certain individuals that could lead to additional scandal and corruption and targeting especially minorities and Hispanics, and especially if the education is not out there, too, as well, based on these that would be available. So I mean, that is the concern that I have as we look at what is going on.

Mr. EGAN. If you are going to give some special consideration to a couple of entities such as a GSE, then encourage them to focus on minority groups and make sure that they actually do their job. They have incentives to do it and monitor it. That is probably the most effective way.

Mr. BACA. That is why the language is very important that is in the proposal to make sure that we have these guarantees.

Mr. EGAN. Yes, but make sure that you do not jeopardize these institutions by ignoring their capital levels.

Mr. BACA. Okay. Thank you.

Chairman BAKER. Thank you, Mr. Baca.

Mr. Shays, you had a quick follow-up?

Mr. SHAYS. Yes, thank you. Just with Mr. Schatz, in his statement he said Fannie and Freddie lagged the private market in supporting the financing of affordable housing. Why is it that Fannie and Freddie basically in spite of their mission don't do as well as banks in terms of supporting the low-income market?

Mr. SCHATZ. Mr. Shays, certainly it is a question to ask when they come up to talk to you. I know the Chairman and others on this subcommittee have had those questions before. I will be happy to forward those studies. But for some reason, maybe it is the Community Reinvestment Act, maybe it is other requirements of banks, they have done better.

One of the things we suggested is to have all of the same regulations and laws that apply to these banks and other lenders, apply to Fannie Mae and Freddie Mac and the Community Reinvestment Act would be one area where they might be forced to participate more in the affordable housing market. And maybe, again, looking at the dichotomy between their mission and their objective to bring the greatest possible return to shareholders, that the returns are not in the affordable housing market. They are in other areas of housing that do not improve that particular area of the marketplace.

Mr. SHAYS. Let me have one last question, Mr. Egan. Let me ask you, will putting Fannie and Freddie under the 1933 and 1934 Acts hurt their ratings, be neutral, or actually help their ratings?

Mr. EGAN. They won't change our ratings because we are comfortable with the ratings where they are. They may change S&P and Moody's ratings if they realize that the capital line is only $2.25 billion and it is not going to grow.

Mr. SHAYS. But there you are just basically saying it is the knowledge that would hurt them, and that in fact would be that they would learn something that already exists, not that we created a new problem.

Mr. EGAN. More disclosure is always an advantage. What is the biggest problem that we see in the market is when there is a big jump, such as when Enron's business was gone, basically, they are only left with one party to go to for a savior, and that was Dynegy. It is a "Hail Mary"-type pass. That didn't work out, and then the whole entity collapsed. We are better off in getting the information out there quickly, making sure it is accurate information, and make sure that the reports, the ratings that are given to the investors are representative of the true risk of these enterprises.

Mr. SHAYS. So basically from your testimony you are saying more disclosure in the long run helps your ratings, rather than hurts them.

Mr. EGAN. Absolutely.

Mr. SHAYS. Okay. Thank you.

Chairman BAKER. Thank you, Mr. Shays.

Mr. Scott, you had a follow-up?

Mr. SCOTT. I want to go back to a moment to this business of derivatives, because I think that is the core of this. Why not just ban the use of the derivatives? Billionaire investor Warren Buffett called them financial weapons of mass destruction. I mean, if he uses that kind of descriptive language, that is enough for me to know that we have a problem here.

Mr. EGAN. From our standpoint, derivatives are just another higher level of ownership. Initially land was wealth; if you owned land, you were wealthy. Then it turned into gold; if you held gold or silver, then you were wealthy. And then it moved into securities. Hold the stock of AT&T or IBM, well, I am wealthy. It is now moving to the point where information is wealth, and you can make investment decisions faster and more accurately by the next level of sophistication, and that is derivatives. The problem is that volatility increases with each step. The land isn't going anywhere. The people are not going to move dramatically over one year or two years. You can still use it for farming or whatever else. The hard assets, they are less volatile. But when you move into stocks, it is a little bit more volatile. And then derivatives are even more volatile. Who knows whether there is going to be an additional layer of complexity.

But the negative is that there is a huge amount of risk. Values can change incredibly quickly. You can put on positions, take off positions within a matter of seconds. So the risk level is there. But to many investors, the benefit is also there too that you are able to hedge a portfolio if you know what you are doing. You can offset some positions inexpensively. So as I said before, it is like nitroglycerin. You know you can move mountains with it, but it can blow you up if you don't handle it properly.

Mr. SCOTT. Right. As we move forward with this legislation, what recommendations do you give this committee to address this issue of derivatives? If this is the core of the problem, if this is one of the major reasons why we are in the shape we are in, if in fact it also was the major reason Enron went down, would we be not fulfilling our obligation if we did not address this in the legislation?

Mr. EGAN. No, but you should make it flexible enough to realize that the market is dynamic; that right now we probably don't have the right information infrastructure in place to manage many of these derivatives. Ideally, what would happen is that all these institutions, not only the GSEs, but also the financial institutions, would have a central clearinghouse for their derivative positions so that a regulator could monitor where they stand, whether or not they are getting into trouble. When Long-term Capital was in the process or failing, you would find out that XYZ Investment Bank had a huge exposure to it. Fortunately the New York Fed was able to step up to the task very quickly over the weekend and save it. But if they weren't, they could have been a real problem.

So I would suggest that the old models for regulating businesses need to be modified. They need to go beyond just the 10K, the 10Q, the traditional ones; developments are moving much faster. It is unrealistic to prohibit the use of derivatives. It is beyond that now. What needs to be done is make sure that the regulation and the monitoring of that fits with the prudent measures; that you are able to manage and see whether or not these institutions are holding enough capital; whether they are offsetting their derivative positions. It is a fairly large task, but it is something that should be addressed over the next couple of years.

Mr. SCOTT. Thank you. May I just finish? I wanted to ask Ms. Karen Petrou, you are with Financial Service Analytics?

Ms. PETROU. Federal Financial Analytics. That is a firm that I am Managing Partner of, along with my husband. We are a small business that provides information and consulting services.

Mr. SCOTT. Very good. You compared the capital base of the 1980s savings and loan disaster with Freddie Mac's current capital ratios. Do you believe that OFHEO has permitted safe capital ratios? If not, what would you recommend should be changed to improve safety and soundness for these GSEs?

Ms. PETROU. I believe that the OFHEO capital rule, their so-called risk-based capital rule, is analogous to the net worth certificates that the then-Federal Home Loan Bank Board established for savings and loans in the 1980s, because it is fake capital. In the old days, the net worth certificates were basically Monopoly money, pieces of paper. The regulator said, "Let's pretend it's capital and hope that you grow out of your problem so the taxpayer does not pick it up," and that was wrong.

Now, we have a much more complex capital rule. It is 700-plus pages long. At the end of the day, what it says is you can count your derivatives as if they were capital. In other words, that nitroglycerin is deemed the equivalent of real shareholder dollars which ought to be at risk first. I do think that is a significant failure that needs rapid attention.

Mr. SCOTT. Thank you.

Chairman BAKER. Thank you, Mr. Scott.

I want to observe that the old rule that Ms. Petrou referenced in her remarks, capital supervision and disclosure, it may not work in every case, but it is a pretty sound formula. On all three counts, we are deficient, in my judgment, at this moment. Now, how we reconcile the deficiency is certainly a matter for the committee to determine. H.R. 2575 is only a point of beginning, not the end of the process.

I do appreciate each of your appearances here today and giving the committee your insights. It has been most helpful. I would point out that for the concerns expressed by those worrying that if we touch in any manner or fashion GSE operations, we will render thousands homeless is not borne out by market performance over the last two days. In fact, as knowledge of H.R. 2575 has been more widely understood, markets appear to have responded favorably because in most views additional information inside the mystical black box of GSE performance is a helpful thing to truly understand the investment risk you are taking by giving them your money.

I believe over the coming weeks and days as more critical analysis is given to the proposal, certainly there may be complaints about a particular provision. I think on balance, however, it will be found to be a reasonable remedy in light of the difficulties we face.

Some have suggested this morning during the course of the committee's conduct that this really is an accounting issue which deserves more examination. To that end, I have contacted the GAO this morning and asked that they within a 90-day period review the current accounting methodologies, the disclosures made by Freddie Mac and analyze the potential impact it may have on Fannie's market standing within the next 90 days so that the committee upon its return from the August recess may examine those findings.

And further to announce that in July upon our return from the Fourth of July recess, the committee will conduct another hearing for one or two purposes: one, to receive any published report that may be ready for public distribution relative to current pending inquiries; or secondly, to examine the advisability of moving forward with H.R. 2575 or both. To that end, I wanted to make those disclosures.

For all those here representing Fannie, Freddie and the Home Loan Banks, if you have comments or questions you would like to forward to me for response, I would be happy to receive them.

Meeting adjourned.

[Whereupon, at 12:30 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 25, 2003

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises

June 25, 2003

"GSE Oversight: The Need for Reform and Modernization"

I want to thank Subcommittee Chairman Baker for convening this important hearing on the oversight of the GSEs. The recent management reorganization of Freddie Mac should give us all pause to assess how well the operations of these GSEs are being monitored by the Office of Federal Housing Enterprise Oversight (OFHEO).

Freddie Mac and Fannie Mae account for billions of dollars in mortgage-backed securities which are widely held by pension funds, mutual funds and individual investors. Given the complexity of these institutions and their importance to the secondary mortgage market it is critical that their regulator be capable of exercising rigorous oversight to ensure their safety and soundness. Over the past six months, as Freddie Mac first announced that it would restate its earnings, and then dismissed its 3 top officers, OFHEO has appeared to be habitually slow to act and unable to predict these crises.

Chairman Baker has been tireless in his review of the issues surrounding the GSEs and was instrumental in the agreement by both Freddie Mac and Fannie Mae to voluntarily register their securities with the Securities and Exchange Commission. This voluntary registration will lead to more transparency into the operations of the GSEs, which will make for a more efficient and better informed marketplace.

The U.S. housing market has remained strong through difficult economic times and is the most sophisticated in the world. This is largely due to the liquidity provided through the secondary mortgage market in which Freddie and Fannie are the key players.

I look forward to hearing from our distinguished panel. Their insights as third party observers will be critical to our consideration of this issue and future actions this Committee may take.

EXCHANGE

Subcommittee on Capital Markets

Richard H. Baker, Chairman

The News from U.S. Rep. Richard H. Baker
Sixth District, Louisiana
FOR IMMEDIATE RELEASE: June 25, 2003
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Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Subcommittee on Capital Markets,
Insurance and Government-Sponsored Enterprises
June 25, 2003
Hearing on Regulatory Oversight of Freddie Mac and Fannie Mae

June 15, 2002, was an important day in the history of our economy. On that day the accounting firm of Arthur Anderson was found guilty of obstructing justice by a Texas jury. This decision ultimately led to the demise of the accounting firm and brought about a thorough reexamination of the entire accounting industry. But frankly, the outcome could have been a lot worse. Our understanding of corporate accounting practices was limited, and action was quickly taken to enhance the regulatory oversight with the passage of the Sarbanes-Oxley Act.

However, there continue to be important elements of our economy, left improperly in my opinion, outside the scope of Sarbanes-Oxley. They are the only two Fortune 500 corporations exempted from these essential reforms. Why were they exempted? The answer was that they are too well run to worry about. They "set the standard to emulate for corporate governance practices." And we want to make sure we never do anything to "throw someone out of a home ownership opportunity."

The events surrounding the fall of Enron were indeed unfortunate not only for the employees, but for all who had financial resources at risk. However, if either of the nation's GSEs were to suffer a financial reversal, the systemic consequences to us all are truly incalculable.

The Capital Markets Subcommittee is meeting today as a result of events that are not of our own making. The announcement by Freddie Mac that their recent accounting practices did not properly reflect their operations, is cause for significant concern. In fact, the initial restatement announcement was again amended just this morning, raising the total misreported income from $1 or $3 billion to $4 billion. This revelation underscores the importance of what has been previously observed by many – that current regulatory oversight is not adequate.

And to those who point out that this is an increase in revenue, not losses, don't miss the troubling point of this news if you were a shareholder. If you sold your interest in the company before this balance sheet adjustment was corrected, you were denied your fare distribution of company earnings by this manipulation. I believe you will find adequate legal filings to confirm this view. More importantly, the explanation given for the misstep is that the corporation did not have enough properly trained staff to oversee the complicated derivatives portfolio. This leads to important questions: Why were they exempted from Sarbanes-Oxley? Where was the regulator during the three years this error went unreported? If Freddie did not have enough invested in staff to properly oversee complex activities, how can anyone argue that OFHEO did?

Congress should be more than just concerned; in fact, we should feel just like any other corporate CEO in America whose oversight has been found lacking. These enterprises are our creation and clearly our responsibility. Today, nothing stands between Congress and the ultimate responsibility should there be a GSE failure. We are the regulator of last resort.

In spite of this circumstance, some still suggest that any examination of the GSEs will result in market instability and potentially throw unsuspecting victims out of home ownership. I have only one question to those who believe this could possibly be true: How is it that a now readjusted restatement figure, up from $3 billion to now a reported $4 billion, over a three year period of operations has not crippled corporate activities and the housing market generally? Is there any action this Congress could take that could possibly approach the significance of this revelation? When such disclosures were made by Enron, Worldcom, and other corporate wrongdoers, the consequences were devastating to employees and shareholders alike. The value of corporations was decimated, and some executives are now in court defending their actions.

What is even more troubling than the restatement at Freddie Mac is the realization that market observers looked past the corporate misstatements and directly into the taxpayers' pockets. There was no reason to be concerned about corporate misconduct, as long as the taxpayers were standing by ready to pick up any loss. This is, in my opinion, the most troubling reality of all. What stands between corporate losses and the pockets of tax-paying working families is the regulator, and not much else.

Looking to the current regulatory structure, in fairness, the effort it made has been significant in light of the resource limitations placed on the organization. If Fannie and Freddie were regulated OCC banks, they would be assessed almost $70 million annually for their regulation. We have fought difficult battles in the appropriations process to get OFEHO to a $30 million level. Either the OCC has it really wrong, or OFEHO is dramatically under-funded, particularly given the financial sophistication of the enterprises. These problems have persisted for too long. It is no longer possible just to put another coat of paint on the walls and regain the respect of the marketplace. It is time to construct a new regulatory mechanism. It must be funded by assessment on the enterprises. It must have real authority to act on par with other financial regulators. It must be constructed to insure independence and marketplace credibility. HR 2575 is built on these principles. I have not proposed any controversial modifications to the charters of either GSE. I have not suggested a repeal of the current line of credit to the U.S. Treasury. I have not included the Federal Home Loan Banks in this proposal. This is a narrowly drawn, carefully crafted resolution, intended not to create political debate, but to effect real change.

This legislation is carefully constructed to bring about only three goals: (1) to insure we have an independent regulator; (2) to insure there is reasonable funding for the supervision; and (3) to equip this regulator with all the tools that any other financial marketplace regulator utilizes. That is it. There should be no controversy over this legislation at all, in light of the revelations over accounting irregularity.

However, where there are identified concerns that can be supported by logical argument, I am open to any constructive modification of the proposal that gets us to the stated goals of this effort. Some may suggest an alternate location for the regulatory home. That's fine. Others may have some objection to a particular enforcement authority. Make those concerns clear. But I cannot envision such disagreements resulting in a failure to act on this reform.

To date we have been fortunate in that no significant reversal in the housing market has occurred on our watch. But do no forget that these enterprises exist as a result of a congressional act. We created them. They continue their favored market position with our concurrence, and as long as there is profit to share, the market works well and shareholders are happy.

The Congress is, however, directly responsible for their supervision and regulation. If we fail in this effort to provide the minimal resources for a competent regulatory structure, the fall will be disastrous. When a GSE fails, it will quickly fall through it's limited capital, and then through the shareholders, landing squarely on the taxpayers. That is an outcome we cannot accept. HR 2575 is a modest step to give some assurance this will never happen.

I began my remarks this morning revisiting the events of June 15, 2002, the day Arthur Anderson was found guilty of obstruction of justice by a Texas court. Another historic event occurred just 24 hours earlier on June 14, 2002. An object known as 2002 MN passed within 75,000 miles of Earth. In astronomical terms this was a "near miss". How close is that in astronomical terms? The closest we approach our moon is about 137,000 miles. So this object passed the Earth, inside the orbit of the moon. As far as we know, this was the second closest near miss of an asteroid impact in human history. So what else is significant about this event? How about this fact? Scientists on Earth did not know about 2002 MN until three days AFTER it passed the Earth.

How is this possible in this world of technological sophistication? The answer is simple. We just don't have enough resources committed or enough people watching to insure against a clearly cataclysmic event from occurring. Now I do not want to turn the Capital Markets hearing into a Science and Technology assessment, but the parallel is clear. Unless we act to enhance our supervisory capacity of the two housing GSE's that Congress created, we may not see the next systemic event coming until it's too late. I sincerely hope that is not your decision.

Today, we will hear from four different individuals and their concerns, and their recommendations for action this committee may consider. It is my hope that the committee will find the adoption of HR 2575 as an appropriate next step in this most important work.

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STATEMENT OF THE HONORABLE WM. LACY CLAY
Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"GSE Oversight: The Need for Reform and Modernization"
June 25, 2003

Good morning Chairman Baker, Ranking Member Waters, Members of the committee and witnesses.

The objective of this hearing is to begin the examination of the structural changes that may be necessary at the Office of Federal Housing Enterprise Oversight (OFHEO) to ensure comprehensive and complete oversight of Freddie Mac and Fannie Mae. As the subcommittee focuses on the current structure of regulatory supervision of the GSEs in an effort to ensure taxpayers and investors are sufficiently protected, let us make sure we are not throwing out the baby with the bath water.

We have tremendous housing issues in this country. There are many, many people who do not have access to decent, affordable housing or access to legitimate loans with reasonable rates. The African American community and the other minority communities suffer the most. Minority homeownership rates lag far behind those of whites. Further, predatory lenders are preying upon all Americans, and particularly African Americans, and are devastating communities across the country.

Fannie Mae and Freddie Mac are a big part of the solution to our housing problems. Also, they are taking leadership in the attack on predatory lending.

These GSEs perform a critical housing mission. In fact, they lead the market in lending to African –Americans and Hispanic families. I have worked tirelessly on this committee and with the GSE's to create affordable housing opportunities. I do not think it prudent that this subcommittee take a step backward. If the end result of this process is legislation which calls for unnecessary delays in the approval of bringing new products and innovation to the market, I oppose this. The issue with Freddie Mac is an accounting one, not an SEC issue. As you know, Fannie Mae is already an SEC-registered company. Their registration with and regulation by the SEC is now mandatory.

The Congress gave Freddie Mac and Fannie Mae the mandate to create a secondary trading market to improve the functioning of home mortgage markets generally. They have done their jobs well and exceeded all expectations. Today, they are the dominant institutions in the secondary mortgage market.

Let me also note that Fannie Mae did not commit any violations or have mismanagement gaffes. Freddie Mac did. Fannie Mae has already been maligned as if it were a partner in this situation. Punish Fannie Mae if and when it does something improper. We need to examine and rate them for the job that they have done and are doing. They are large because they are good at what they do. Ideally, that is the expected result in American business dealings. Those that do it best normally grow to be the biggest. Are we to punish for that? At this point, we should thank Fannie Mae, not spank them.

Mr. Chairman, I am not alone in my support of Fannie Mae and Freddie Mac. Recently, the 600 member National Black Caucus of State Legislators; the 60 affiliate Opportunities Industrialization Centers of America, and 4,300-member World Conference of Mayors unanimously passed a resolution opposing any congressional or state changes to Fannie Mae's status or mission. I support this resolution because, while I believe Congress must untangle the accounting problem at Freddie Mac, Congress must not hamstring the affordable housing mission of these GSEs with unnecessary regulatory burdens.

Mr. Chairman, I ask unanimous consent to submit my remarks for the record.

June 25, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing entitled, "GSE Oversight: The Need for Reform and Modernization"

Thank you, Mr. Chairman, for holding this important and timely hearing to evaluate the current regulatory structure for Government Sponsored Enterprises (GSEs). I appreciate your strong leadership on this issue.

Late last year, in the wake of the Enron scandal and subsequent revelations of widespread problems in the accounting industry, the Federal Home Loan Mortgage Company (Freddie Mac) announced that it would have to restate its earnings after it fired its former auditor, Arthur Anderson, and hired Price Waterhouse Coopers.

This reevaluation kept Freddie Mac from upholding their voluntary agreement to file with the Securities and Exchange Commission (SEC) as the Federal National Mortgage Association (Fannie Mae) did in April of 2003. Two months later the Office of Federal Housing Enterprise Oversight (OFHEO) released its annual report to Congress addressing the upcoming earnings restatement by Freddie Mac, while expressing satisfaction with the independence of their internal and external audits and confidence in the actions of Freddie Mac's Board of Directors.

Only three days later, Freddie Mac announced the termination of its President and Chief Operating Officer, David Glenn, the retirement of its Chief Executive Officer, Leland Brendsel, and the resignation of Vaughan Clark, their Chief Financial Officer. The Board of Freddie Mac revealed that Mr. Glenn was terminated for failing to cooperate with their internal investigation following the restatement of earnings.

It concerns me greatly that the responsible federal regulator, OFHEO, was clearly unaware of these problems inside the management of Freddie Mac and was previously unaware of their need for an earnings restatement. Clearly, OFHEO was not doing its job.

I am happy to be an original cosponsor of Chairman Baker's legislation moving Fannie Mae and Freddie Mac under the supervision of the Office of Thrift Supervision (OTS). Today, I look forward to learning more specifics regarding Freddie Mac's accounting problems and to address the current nature of these large GSEs and the privileges appropriate given their standing in the secondary market.

Thank you again, Mr. Chairman, for calling this important hearing and I look forward to future discussions on this issue.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON GOVERNMENT SPONSORED ENTERPRISE OVERSIGHT: THE NEED FOR REFORM AND MODERNIZATION

WEDNESDAY, JUNE 25, 2003

Mr. Chairman, our nation's system for housing finance is not only extremely successful, but it is also the envy of the world. Almost 68 percent of Americans own the homes in which they live. Government-sponsored enterprises have contributed greatly to this accomplishment.

This success, however, should not stop us from asking whether and how we can do a better job with respect to regulating Fannie Mae and Freddie Mac. We should always examine ways by which we can improve regulatory efficiency and lower mortgage rates. The recent events at Freddie Mac related to its earnings restatement and its management changes have highlighted the need for the continued examination of these matters.

As you know, Mr. Chairman, I am also one of the few remaining Members of this Committee who participated in the entire congressional battle to resolve the savings and loan crisis. I am therefore acutely aware of the need to protect taxpayers from risk. It is in the public's interest that we ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We must further ensure that these public-private entities achieve their public responsibilities for advancing homeownership opportunities.

We can best achieve these dual objectives by pursuing a three-pronged supervisory approach that includes regular congressional oversight of, sustained effective government regulation over, and increased market discipline for the two GSEs. Through our extensive studies and hearings over the last forty months, we are fulfilling our obligation in the Congress to conduct regular oversight of the GSEs.

Although we have not reached consensus on legislative reform during the last dozen hearings on GSE regulation, I do believe that we have reached agreement on at least several key points. First, we have agreed that we have the world's most successful housing finance system and gained an appreciation for the important role that the GSEs play in that system. Second, we have agreed that Fannie Mae and Freddie Mac have grown significantly in recent years. Finally, we have agreed that we must have strong regulators for the housing GSEs.

As I said at our very first hearing on GSE regulation in March 2000, "we need to have strong, independent regulators that have the resources they need to get the job done." I continue to support strong GSE regulation. A strong regulator, in my view, will protect the continued viability of our capital markets, insure against systemic risk, and expand housing opportunities for all Americans.

To ensure that we have strong GSE regulation, I believe that any legislative reforms considered by the Congress in the future should adhere to at least five key principles:

(over)

- First, in order to conduct robust supervision, a strong regulator must have a funding stream separate and apart from the annual appropriations process.
- Second, a strong regulator must have a single leader for a set term with sole responsibility for making decisions.
- Third, a strong regulator must be independent and free from political interference.
- Fourth, a strong regulator must focus like a laser exclusively on GSE issues. The GSEs warrant a specialized regulator focused on one goal and without multiple responsibilities.
- Fifth, a strong regulator must have enhanced supervisory and enforcement powers similar to those of other federal regulators for financial institutions.

The primary goal of today's hearing is to advance our examination of what structural changes might be necessary at the Office of Federal Housing Enterprise Oversight or the Department of Housing and Urban Development to ensure comprehensive and complete oversight of Fannie Mae and Freddie Mac. Today we will hear primarily from one side of the debate: those who have often been critical of the GSEs and their regulators. In fact, many of our witnesses have already called on the Congress to reform GSE regulation, alter their statutory structure, or disband these entities altogether.

As we proceed in the future, it is my hope that we will develop a balanced, deliberate and bipartisan plan of action for addressing GSE matters. In other words, we should move judiciously and objectively in conducting our oversight responsibilities. We also should understand the facts behind the recent events at Freddie Mac before developing any legislation.

Moreover, we should not once again upset the securities markets. On at least one occasion, our Committee's actions have unfortunately discouraged investors and raised homeownership costs. As we proceed today, we must renew our efforts to ensure that we do not repeat that mistake.

In closing, Mr. Chairman, I commend you for your continued leadership on these issues. I will also continue to work with you to conduct effective oversight over the housing GSEs and to ensure that we maintain an appropriate and sufficiently strong supervisory system for them.

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Statement of Rep. Carolyn Maloney
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
June 25, 2003
"GSE Oversight"

Oversight of the GSEs is one of the most important issues over which the Financial Services Committee presides. These institutions are pillars of our housing system and millions of our constituents benefit from the liquidity they provide our lending institutions.

At the same time, the recent events at Freddie Mac are deeply troubling. While the company's new leadership is trying to repair the damage – the reality of the accounting and corporate governance shortcomings that occurred at the company are unsettling given size of the institution.

I joined this Committee just as the country was emerging from the S&L crisis. Because of this experience, I regard Congressional oversight of the safety and soundness of the financial services industry as our most important responsibility.

In this regard, I have long supported efforts to provide more resources to the Office of Federal Housing Enterprise Oversight (OFHEO). While OFHEO has enjoyed budget increases in recent years, it is still subject to the appropriations process which clearly weakens its independence. Last year, along with Rep. Ken Bentsen, Chairman Baker, and Ranking Member Kanjorski, I cosponsored legislation to remove the agency from the appropriations process – and I believe strengthen its hand. As a point of history, any examination of OFHEO must also note that it took years longer than it should have for the agency to promulgate its risk-based capital rule.

Despite these shortcomings in OFHEO's past, I do believe in taking a deliberate and thorough approach to legislating major changes to our nation's housing markets. Before acting we need to know exactly what happened at Freddie Mac and whether it represents a one time occurrence or larger problem.

The U.S. mortgage market is the best in the world. As we all know, in the current low interest rate environment mortgages are being refinanced a record rate that would be impossible without automation from laws like the FCRA and our incredibly successful mortgage finance system. The *Washington Post* detailed the impact that the ability refinance so easily is having on the economy in a June 8, article. The article stated that:

- Since 2001, banks will have processed more than 27 million mortgage refinances by the end of this year
- Out of those, homeowners will have converted more than $ 270 billion of home equity into cash, either to spend or convert high-interest debt into very low interest loans
- At least another $ 20 billion was freed up in lower monthly mortgage payments
- In total, since 2001 refinancing will have delivered about $ 300 billion directly to consumers who will have more money to spend and pump up the economy.

That is in comparison to the $263 billion that the Bush tax cuts of 2001 and 2003 will have put in the economy by year's end.

I thank the Chairman for calling this hearing and to working with the Subcommittee to make sure our housing system remains preeminent in the world.

Opening Statement
Congressman Ed Royce (CA-40)
25 June 2003
"GSE Oversight: The Need for Reform and Modernization"

Thank you, Mr. Chairman, and thank you for holding this hearing on "GSE Oversight: The Need for Reform and Modernization." I would like to commend the chairman for his unwavering commitment to the topic of GSE regulatory reform. I also greatly look forward to hearing what today's witnesses have to contribute to the ongoing discussion initiated by this subcommittee on this topic.

Government Sponsored Enterprises ("GSEs") focused on home ownership have been in existence since 1934. And, since that time, GSEs have played an important role in developing the secondary mortgage market in the United States. Fannie Mae and Freddie Mac buy mortgages from originators in order to provide liquidity in the market, and the Federal Home Loan Bank System provides advances to banks and thrifts so that those organizations can offer mortgage products to their customers.

Like the rest of corporate America, overtime the GSEs have developed comprehensive business models to achieve their mission and to get results for their shareholders. As a result, the housing GSEs have become three of the most sophisticated financial institutions in the world. In total, the three GSEs have over $2 trillion in debt, and a derivative portfolio with a notional amount totaling over $1.9 trillion. As a result of their evolving business models, the three housing GSEs now must protect their balance sheets not only from credit risk but also from interest rate risk. With these facts in mind, I think that it is crucial that these organizations are subject to competent regulation.

I regret to say that I do not have enough confidence in The Office of Federal Housing Enterprise Oversight ("OFHEO"), which regulates Fannie Mae and Freddie Mac, or in The Federal Housing Finance Board, which regulates the Federal Home Loan Bank System. I believe that we need to fold these two regulatory bodies into a new agency under the umbrella of the Treasury Department. In my view, such a regulatory institution will have better direction through its association with the Treasury and its sister regulators the OCC and the OTS. The new regulator will also have the ability to achieve "best practices" of regulation because it will have a broader scope than either OFHEO or the FHFB has today -- and -- it will be focused on protecting the taxpayer from like types of systemic risk.

I think that it is important for this Committee to act on this matter. Through perception, reality, or both, all three housing GSEs are inadequately regulated. I look forward to working with my colleagues to create a new, more effective regulatory structure for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. I would like to thank our witnesses here today, and would once again like to thank Chairman Baker for his longstanding interest in this issue. I yield back.

Opening Statement of Congressman Christopher Shays

Capital Markets, Insurance, and GSE Subcommittee

"GSE Oversight: The Need for Reform and Modernization"

June 25, 2003

I want to thank Chairman Baker for holding what I hope will be the first in a series of hearings on the need to strengthen the regulation of Fannie Mae and Freddie Mac. These hearings are a continuation of our subcommittee's, and especially our chairman's, excellent work in examining the safety and soundness of these two government-sponsored enterprises (GSEs).

A funny thing happened on the way to the forum. On June 9, mortgage giant Freddie Mac announced that its three top executives were leaving the company and that there would be a further delay in the long-promised restatement of its financial results for not one, not two, but three years.

These announcements came less than a week after Freddie Mac's *alleged* regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), gave Freddie Mac a clean bill of health, stating it "remain[s] satisfied that the Board of Directors and executive management are taking the appropriate action."

Freddie Mac is the fourth largest financial services company in the United States, yet its regulator had no idea what was happening within the company's walls. Freddie Mac is restating its earnings and endlessly delaying release of that restatement, yet the securities laws can barely touch it. The Securities and Exchange Commission (SEC) has a panoply of powers to regulate every other publicly traded company in the country, but has little authority over Freddie Mac and its sibling, Fannie Mae.

Equally troubling is a recent statement in the congressional newspaper, *The Hill,* by a Freddie Mac lobbyist who said, "We feel good about these hearings because this is a great story to tell – the restatements [of earnings] are going to be up, not down." This comment is designed for financial dummies. Systematic accounting fraud may have been committed – but it's a "great story" because earnings are higher?

What's more, we now know that just two business days before Freddie Mac's stock plummeted by 21 percent, five top company officials, including fired President David Glenn, sold over half a million dollars worth of company stock. While there may be a perfectly innocent explanation for these insider stock sales, such as a pre-arranged selling plan, the fact they occurred when these company insiders were likely to have been in possession of material non-public information – information whose disclosure could reasonably be expected to, and ultimately did, have a material impact on Freddie Mac's stock – raises very serious questions regarding whether possibly illegal insider trading may have occurred.

All of this brings us to today's hearing, which I hope will lead to the enactment of legislation that reforms these two enormous and important financial institutions.

Yesterday, Chairman Baker introduced legislation that abolishes OFHEO and creates a new safety and soundness regulator within the Department of the Treasury. This new, independently-funded regulator will have real authority to open up Fannie and Freddie's books and protect the interests of taxpayers and investors.

But establishing a new safety and soundness regulator, which I wholeheartedly support, is only part of the solution. We also need to strengthen the oversight of Fannie and Freddie's securities.

Fortunately, a strong regulator already exists. It's called the Securities and Exchange Commission, and it's been successfully regulating every publicly-traded company for seven decades. Well, *almost* every company.

When it comes to securities disclosure, the problem isn't a weak regulator. Quite the contrary. The problem is the exemption enjoyed by Fannie Mae and Freddie Mac from the federal securities laws.

When Chairman Baker's legislation is considered by this subcommittee – and I hope it's considered soon – I intend to offer an amendment to strengthen the regulation of Fannie Mae and Freddie Mac by repealing their special exemption from the Securities Act of 1933 and the Securities Exchange Act of 1934. The result will be a bill that provides for a strong safety and soundness regulator and equally strong securities disclosure.

Mr. Chairman, I thank you for calling this hearing and look forward to hearing from our distinguished panel of witnesses.

STATEMENT OF
Dr. Jay Cochran, PhD
Mercatus Center at George Mason University
Arlington, Virginia

Before the House Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives
Congress of the United States

ON GOVERNMENT SPONSORED ENTERPRISES (GSES)

June 25, 2003

Good morning Mr. Chairman, members of the committee, ladies and gentlemen. Thank you for the opportunity to comment today on Government Sponsored Enterprise (GSE) Oversight: The Need for Reform and Modernization.

I am Jay Cochran, a Research Fellow in Regulatory Studies at the Mercatus Center at George Mason University, and adjunct professor of economics at GMU. Our mission at the Regulatory Studies Program is to advance knowledge of the impact of regulations on society by conducting careful and independent analyses using contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, the work we do does not represent the views of any particular affected party or special interest group, but rather is designed to evaluate the effects of government policies on overall consumer welfare. *I would like to emphasize that the views I express today are my own and do not represent an official position of George Mason University.*

I, along with Catherine England, professor of finance at Marymount University, authored a study in 2001 that covered the history, regulatory structure, as well as the costs, and benefits of the big three GSEs in housing finance—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Our study was titled, "*Neither Fish Nor Fowl: An Overview of the Big-Three Government Sponsored Enterprises in the U.S. Housing Finance Markets.*" I ask, Mr. Chairman, that the 2001 study be incorporated into the record as part of my remarks here today.

Our aim then, as now, in writing that study was to bring a measure of objectivity to a subject that, as I am sure everyone on this committee is well aware, can be quite contentious. Along those lines, I have three main goals today: (1) to update some important parts of our study, (2) to discuss some of the risks presented by the GSEs, and (3) to briefly discuss oversight and regulatory issues. In covering these three areas, it is my intent to shed some additional light on the ways in which we choose as a society to finance home purchases and thus to help this committee as it considers various policy options.

Updates to the 2001 Study

In assessing the costs and benefits provided by the GSEs, my coauthor and I essentially followed the methodologies of previous studies by the CBO, GAO, and other (non-government) authors. As in those studies, we estimated the value of the GSEs' charter-conferred privileges, such as SEC filing exemptions, state and local income tax exemptions, US Treasury lines of credit, and the ability to borrow in capital markets at rates lower than AAA-rated corporate borrowers. We treated the value of these charter-conferred privileges as approximations of the social costs of the present GSE mortgage finance setup. On the benefit side of the ledger, we estimated the savings in mortgage finance costs that the GSEs' operations confer on home buyers, and this figure is approximated by the difference between rates available on conforming mortgages and the rates paid on jumbo mortgages. Then, the difference between our cost and benefit estimates gives an estimate of the net social benefits (or costs) the GSEs provide to the US economy as a whole.

Mr. Chairman, between 1995 and 2000, we estimated that the GSEs' operations conferred net social benefits ranging from a high of slightly more than \$10.0 billion in one year, to a low of just under \$2.0 billion in another. Using the same methodology and data sources as in our original study, it is possible to update our estimates to include 2001 and 2002. Doing so and using the more conservative methodology employed by CBO, shows that GSE net benefits declined to roughly \$1.0 billion in 2001, and fell again in 2002, to just above break-even. These updated estimates reveal that the net benefits margin has continued an essentially downward trend that has been in place now since 1998. (Figure 1, attached at the end of this statement, shows the pattern of our costs and benefits estimates.)

Increasing Size, Increasing Risk

On this latter point of rapidly growing balance sheets, the big three GSEs' on-balance sheet assets have grown at compound annual rate of more than 18% since 1995—going from $726 billion in 1995, to just under $2.4 billion by the end of 2002. Freddie Mac was the fastest grower, going from $137 billion in assets in 1995 to more than $721 billion by 2002 (27% annual growth), while Fannie Mae went from $316 billion in assets in 1995 to $887 billion by 2002 (16% annual growth). By comparison, real GDP over the same period grew by roughly 3% per year, while the overall US residential mortgage market grew by 9% per year.

By itself, rapid growth is not necessarily troublesome so long as general principles of financial safety and soundness are followed. And one of the most important principles of sound finance is diversification—not having all of one's eggs in one basket. For the last several years, though, Fannie Mae and Freddie Mac have been placing more of their own eggs in their own baskets. Since 1995 in fact, the volume of their own mortgage-backed securities the two firms have elected to hold in portfolio has grown from a combined $125 billion in 1995 to nearly $850 billion in 2002—a growth rate of better than 30% a year on average.

In this connection, it is well to recall that Congress's original aim in creating the GSEs was to help the banking and thrift industry offload and spread the risks of mortgage finance and in so doing, lower financing costs and thereby encourage home ownership. By creating an active secondary market in mortgages, Congressionally chartered GSEs developed an outlet through which banks could conveniently liquidate mortgage loans and thus better match their asset and liability maturities. Moreover, by acting as a conduit between mortgage borrowers and mortgage investors, the GSEs also helped to spread the risk of housing finance to those most willing and able to bear it. If, however, as suggested above, the GSEs are now increasingly holding more of their own mortgage-related products in portfolio rather than selling them to investors, mortgage-lending risks may again be concentrating in one place in the economy rather than dispersing throughout it. (Figure 2, attached to the end of this statement, shows the trend in mortgage-backed securities held in Fannie Mae and Freddie Mac's portfolios.)

In answer to the claim of increasing risk concentration, to their credit, the GSEs cite adequate risk protection through hedging activities using swaps and other derivative-related instruments, as well as through private mortgage insurance and other means. However, their claims beg the question of counterparty risk. In other words, are the institutions on which the GSEs are relying for risk sharing financially sound, and are they likely to remain so during less than ideal economic conditions? And even beyond that basic question of financial soundness, if banks are important counterparties to the hedging and risk control operations of the GSEs, then in an important if less obvious way, the risks attendant with mortgage finance may be quietly re-entering the banking system, only this time through an off-balance sheet side door.

GSE Oversight

With respect to oversight, the federal government regulates the GSEs for two reasons. First, GSE debt represents a potential liability to the federal government. The GSEs have explicit lines of credit with the Treasury, and many market participants behave as if the federal government would guarantee GSE debt in the event of default. Federal supervision is also needed to protect private competitors from undue expansion by the GSEs. Their relationship with the government can give GSEs a competitive advantage that can enable them to crowd out private firms especially when the GSEs are allowed to move into already-occupied market segments. Because market discipline of the GSEs in terms of risk-taking and competitive inroads may be muted, and in some cases reversed altogether, regulatory oversight is required if the present market structure in housing finance is to be preserved.

In the remainder of my remarks on oversight, I will focus on the Office of Federal Housing Enterprise Oversight (OFHEO), and lay aside oversight questions regarding the Home Loan Banks. With respect to Fannie Mae and Freddie Mac's safety and soundness regulation, I am confident that the staff of OFHEO is well intentioned and doing the best job they can, given the economic and political constraints they face. To their credit, their work on safety and soundness over the past decade has not upset the capital markets, and the housing finance markets, from all outward appearances, have functioned smoothly throughout the period.

However, no realistic assessment of GSE oversight can ignore the fact that OFHEO consists of just over 100 people operating on a $30 million annual budget. Yet this small organization is expected to oversee the operations of two enterprises that, combined, held over $1.6 trillion in assets at the end of 2002, and produce business volumes on a monthly basis in the billions of dollars. This vast disparity in size and resources may explain in part why, for example, OFHEO gave Freddie Mac and its audit procedures an unqualified endorsement in its most recent report to Congress, only to have that endorsement undermined by recent events. It may be pertinent, therefore, for the committee to ask whether the agency can continue to attract the best talent with the latest skills that match those of the GSEs they are expected to monitor.

It is also noteworthy that it took the agency nearly 10 years to develop a risk-based capital (RBC) standard for the GSEs. To be sure, from the descriptions of it in OFHEO's annual report to Congress, the RBC standard is built on a sophisticated and complex model. It models, for example, the projected future cash flows of over 200,000 different instruments in the GSEs' portfolio and subjects those projections to a variety of interest rate and housing price shocks. Still, I can't help but be concerned, given my earlier remarks about diversification for example, that we have substituted modeling sophistication for adherence to basic principles of sound finance.

Nevertheless, even accepting that the RBC accurately models GSE risk over a variety of scenarios, there remains a possibility that a narrowly focused agency like OFHEO can be (or can become) too parochial. That is, from its relatively narrow vantage point in the economic system, it may not be especially well equipped or properly situated to consider the overall or systemic consequences of GSE operations on the broader capital and credit markets for example.

Conclusion

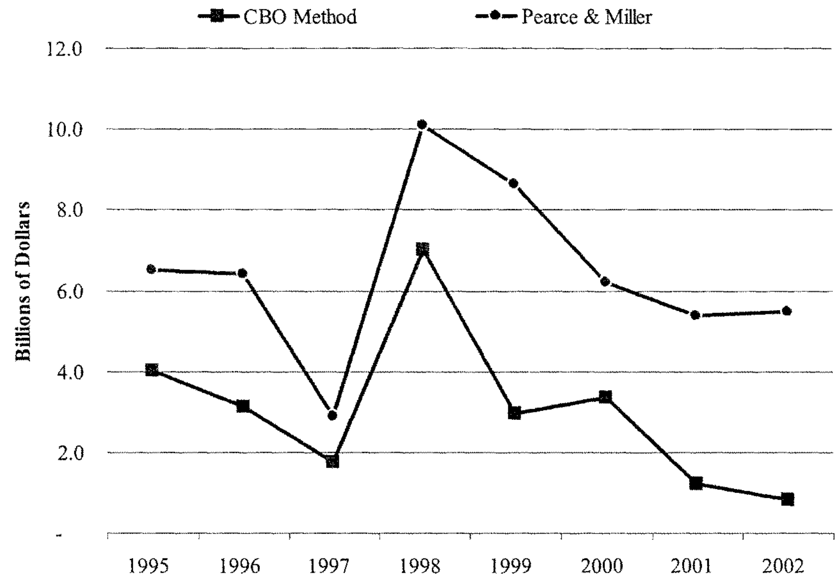
In conclusion: Clearly, the three housing GSEs have delivered benefits, not only to their owners, but also to homebuyers and lenders. The GSEs, for example, helped to pioneer long-term amortized mortgages. Moreover, GSE efforts to create a secondary mortgage market and to standardize loan contracts have simplified comparisons and reduced transactions costs throughout the life of a mortgage loan. Furthermore, increased liquidity of mortgage loans as well as better tools to spread risks across investors have contributed to reduced mortgage interest rates compared to what they would have been otherwise.

Despite these innovations, however, one must always keep in mind that the GSEs are neither fully responsive to market forces nor to government control. To the extent GSEs' cost structures do not reflect market-driven costs and their operating venues are protected from competitive encroachment, GSEs face muted market discipline. Nor are the GSEs government agencies and thus subject to the budgeting process and other institutional controls. Government oversight of the GSEs is thus limited. Being neither fish nor fowl—neither fully private nor fully public enterprises—prudence and rational public policy dictate that the GSEs undergo regular scrutiny by government and market participants. With respect to this latter point in particular Mr. Chairman, I would like to applaud you and the members of this committee for your steadfast willingness to undertake this difficult but necessary responsibility.

Thank you.

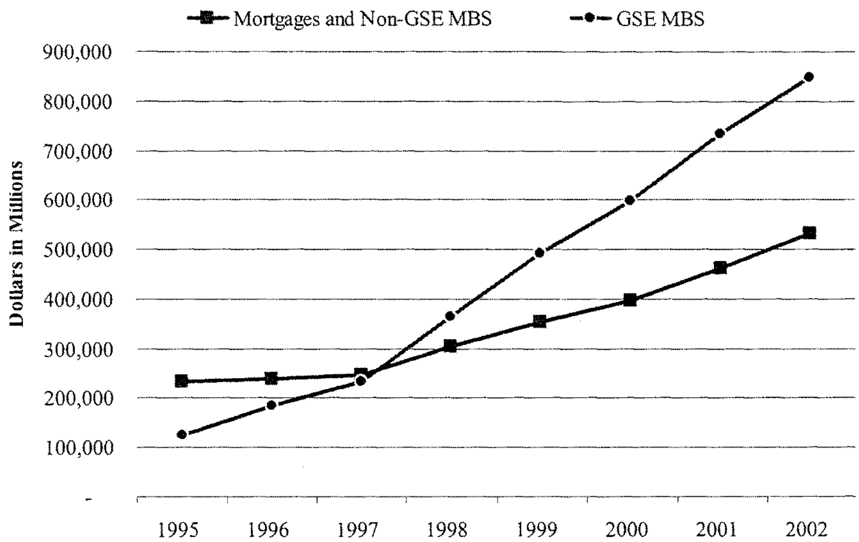
Figure 1

Estimates of Net Social Benefits Conferred by GSEs



Source: "Neither Fish nor Fowl: An Overview of the Big-Three Government Sponsored Enterprises in the U.S. Housing Finance Markets," (2001), Mercatus Center at George Mason University, and the citations to data sources and studies incorporated therein.

Figure 2
Mortgages and MBS Held in Portfolio
by Fannie Mae and Freddie Mac



Source: GSEs' Annual Reports, various years.

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Providing timely, accurate credit ratings to Institutional Investors

Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Co.
Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
June 25th Hearing – GSE Oversight: the Need for Reform and Modernization

Chairman Baker, members of the Subcommittee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit ratings firm. By way of background, I am a cofounder of Egan-Jones Ratings Co., which was established to provide timely, accurate credit ratings to institutional investors. Our business model differs significantly from that of other ratings agencies in that we are not paid by the issuers of debt, which we view as a conflict of interest. Instead, we are paid by approximately 300 firms consisting mainly of institutional investors and broker/dealers. Unlike the major rating firms, we provided early warnings to investors on major debacles such as Enron, WorldCom, Global Crossing, Genuity, and ABB. We are based in the Philadelphia Pennsylvania area, although we do have employees that operate from other offices.

The three areas I would like to briefly address today are the GSE's current status, their development, and our proposed reforms.

GSE's Current Status

Fannie Mae (Fannie) and Freddie Mac (Freddie), (collectively the GSE's) started life under the protection of the Federal government and were given a line of credit from the US Treasury. When the GSE's were relatively small, the $2.4 billion line of credit from the US Treasury was adequate. As can be seen in the below chart, the GSE's capital (including the US Treasury line of credit) was adequate compared to other financial institutions.

	2000	2001	2002
Fannie Mae			
Total Assets ($BB)	675	799.8	877.5
Shareholders' Equity ($BB)	20.8	18.1	16.3
Equity/ Assets	**3.1%**	**2.3%**	**1.9%**
Fixed Charge Coverage (x)	1.2	1.2	1.2
Return on Avg. Assets (%)	1.0	1.1	0.7
Freddie Mac			
Total Assets ($BB)	459.3	617.3	721.7
Shareholders' Equity ($BB)	14.8	15.3	24.6
Equity/ Assets	**3.2%**	**2.5%**	**3.4%**
Fixed Charge Coverage	1.1	1.2	1.3
Return on Avg. Assets	0.8	1.2	1.2

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Fannie's shareholders' equity has declined from $20.8 billion as of December 2000 to $16.3 billion as of December 2002 while assets have grown from $675 billion in Dec. 2000 to $887 billion in Dec. 2002. As the GSE's grew, they were not able to grow their capital base sufficiently to keep pace with the rapid asset growth; what used to be high leverage has become excessive.

Below is a comparison of the GSE's credit ratios to other firms' ratios.

	Moody/S&P Ratings	Return on Avg Assets	Return on Perm Cap(%)	Fixed Charge Cov (x)	T Debt/ Cap (%)
FANNIE MAE	Aaa/AAA	0.7	0.7	1.2	98.1
FEDERAL HOME LOAN MORTG CORP	Aaa/AAA	1.2	1.2	1.2	97.4
COUNTRYWIDE FINANCIAL CORP	A3/A	2.8	3.4	2.7	89.2
SLM CORP	A2/A	2.3	2.4	2.0	96.0
ADVANTA CORP	B2/B	0.1	0.2	1.3	56.4

Egan-Jones Ratings currently rates Fannie Mae (FNM) at "A+", which is approximately 4 notches below S&P's and Moody's "AAA" and "Aaa" ratings (Egan-Jones uses the same rating categories as S&P in the investment grade segment). Attached is a history of our ratings and below are comments from a June 10, 2003 report on FNM

> Far from a "AAA" - FNM is not fully backed by the US and has only a sliver of equity. The general rule for banks is to maintain equity at 8% of assets; FNM has only 1.96%. Also FNM has greater volatility than some banks because of its business focus and the absence of loan prepayment penalties. Although FNM claims it is hedged there are few perfect hedges. Still unresolved is the support FNM will get from the Federal Government if it gets into trouble. FNM's prospectuses state that the Federal Government is under no obligation to support FNM, but most investors assume it will, [but probably up to only $2 billion.] The assumption of the US's guaranteeing all of FNM's debt and shareholders' getting the upside is likely to change.

Egan-Jones Ratings currently rates FRE at "A", which is approximately 5 notches below S&P and Moody's "AAA" and "Aaa" ratings (Egan-Jones uses the same rating categories as S&P in the investment grade segment). Attached is a history of our ratings and below are comments from a June 10, 2003 report on FRE.

> FRE is not a "AAA" credit and the replacement of its top three officers and restating its financials is not comforting. The items of

> greatest concern are the prepayment of high rate mortgages (which are replaced at a reduced rate), the non-callable status of some liabilities, hedging costs, and low equity. Although FRE's prospectuses state that the Federal Government is under no obligation to support FRE, most investors assume it will. The model of the Government's guaranteeing FRE's debt and shareholders' getting the upside is likely to change. Perhaps FRE will go the way of SLM Holdings [i.e., Student Loan Marketing Association].

A reasonable question would be why one rating firm, Egan-Jones, would rating the GSE's at "A" and A+" whereas Moody's, S&P, and Fitch would rate the GSE's at "AAA". Our view is that 1) there is substantial pressure for the major rating firms to maintain high rating for major issuers and 2) little penalty if the rating ultimately proves to be wrong. Regarding the pressure to maintain a high rating, Moody's, S&P and Fitch obtain approximately 90% of their revenues from issuers such as the GSE's.

> Over the years, S&P and Moody's have rated more than $500 billion in Freddie Mac debt and earned tens of millions of dollars in fees.
> Wall St. Journal, June 12, 2003

Unlike Moody's, S&P, and Fitch, Egan-Jones is not paid by issuers for its ratings. Regarding the lack of penalty if Moody's, S&P, and Fitch's ratings prove to be drastically wrong, since there are relatively few alternatives, the major rating firms face few penalties. Up until early this year, the three major rating firms were the only firms recognized by the SEC and DBRS, which was recognized in March 2003, has little market presence in the U.S. Over the past three years there have been numerous examples of investment grade firms filing for bankruptcy protection on short notice. Enron was rated investment grade four days before its filing, National Century was rated Aaa two months before its filing, WorldCom was rated at the Baa/BBB level three months filing, and the California utilities were rated at the A level 16 days before defaulting. Despite these failures, the major rating firms have regularly grown their revenues because of the restrictions on competition.

The GSE's Development

Enron, Worldcom, Global Crossing and the current situation with the GSE's highlight some structural deficiencies in our financial system. Although the GSE's state in their prospectuses that their support from the US Treasury is limited to $2.2 billion, the major participants in the financing process have told investors otherwise.

> When **Freddie Mac**'s stock fell Monday on news of a management ouster and audit delay, UBS Warburg analyst Gary Gordon quickly

> weighed in with his support: He deemed the management change a "positive" and reiterated a "buy" rating on the shares. Even as Freddie Mac's stock slid 16% to $50.26 a share that day, he reiterated his price target of $105. As it happens, **UBS** ranks No. 1 in underwriting Freddie Mac's mortgage-backed securities over the past year and a half. While fees for such issues aren't disclosed, UBS was the lead manager on $84 billion of Freddie Mac mortgage securities in 2002 and 2003, according to Thomson Financial, which tracks securities activity. Of the five Wall Street firms that cover Freddie Mac and received the biggest slice of its mortgage-backed securities business in 2002 and 2003, only one downgraded the stock this week. Besides UBS, **Credit Suisse Group**'s CSFB, **Citigroup** and **Lehman Brothers** all reiterated their ratings for Freddie Mac. **Bear Stearns**, which ranked second in mortgage-backed securities business with Freddie Mac, lowered its ratings on the stock, to "peer perform" from "outperform."
>
> Heard on the Street, WSJ Online, June 12, 2003

The large rating firms hold themselves as independent, a misnomer since they receive 90% of their compensation from issuers and the GSE's happen to be two of the largest issuers. S&P, Moody's and Fitch maintain ratings of "AAA/ Aaa" on the GSE's.

While accountants often are criticized for the quality and thoroughness of their work, that is a secondary issue here. The basic problems are insufficient capital and a changing business environment. Both GSE's have experienced the early prepayment of assets and difficulty in reinvesting proceeds at previous rates. Hedging helps, but there are few perfect hedges, and the significant size of the GSE's makes extensive hedging problematic. The regulatory environment could be characterized as lax and inconsistent; it is difficult to excuse regulators' having allowed the GSE's financial leverage to become so great.

Proposed Reforms
Although the GSE's have been and will continue to be important contributors to the financing of home mortgages, their significant size does not provide an excuse for not addressing the problems in the market. We recommend action in the following areas:

1. Establishment of a Regulatory Body – Heretofore the GSE's have acted with minimal overview of their activities while encouraging the view that they are supported by the federal government. If the GSE's retain any support from the federal government, then adequate controls have to be put in place addressing issues such as capitalization, asset acquisition practices, hedging practices, servicing firm reviews, asset and liability diversification, tenor of asset and liabilities, interest rate risks, portfolio sensitivity analyses, workout procedures, capital raising procedures, operating systems, documentation review, local tax (property, school, and sewer) payment monitoring, and management development. The regulator should have experience examining large, complex financial institutions and be insulated from the GSE's extensive lobbying efforts.

2. Restrict Growth/ Rebuild Capital – Unless the federal government is willing to increase its credit line to the GSE's to approximately $70 billion each (at least 8% of total assets), the GSE's need to increase capital if they are to survive in their form.

3. Encourage the Development of Additional Funding Sources – Concentrating funding for a critical sector such as housing with two firms (according to Bloomberg, the GSE's own or guarantee approximately 40% of the US mortgage market) is unwise regardless of the quality of management of the two firms. Just as the commercial and investment banking fields have a variety of capable firms, the mortgage sector should likewise have a variety of significant competitors.

4. Enhance Rating Firm Independence – all the current SEC-recognized rating firms receive most of their compensation from issuers and have fallen short in protecting investors. If the NRSRO system is retained, then (i) recognize some rating firms that are independent from issuers and (ii) over time, restrict SEC-recognized rating firms from receiving compensation from issuers.

Comment on Legislative and Regulatory Actions
Although some (particularly the GSE's) have encouraged a policy of benign neglect toward the GSE's, we believe the problem will grow if it is not addressed. The markets are confused about the condition of the GSE's currently; although the major rating firms have issued "AAA" ratings, investors have been burnt by Enron and WorldCom, which had strong investment grade ratings prior to their failure. Markets dislike uncertainty, and therefore legislation on the GSE will provide more clarity to confused investor

Appendix

Egan-Jones and its Rating of the GSE's

Below is a listing of Egan-Jones's rating actions on Fannie Mae and Freddie Mac. Note, Egan-Jones is not paid by issuers for its ratings. The corporate bond investment unit of Freddie has been a client of Egan-Jones for the past several years, while Fannie is not a client. Freddie pays our normal subscription price and represents less than 1% of Egan-Jones' revenues.

Fannie Mae's Senior Unsecured Ratings

Date	Egan-Jones*	S&P	Moody's	Fitch	Action
4/10/2001	AA (neg. watch)	AAA	Aaa	AAA	EJR issued neg. watch (AA)
2/20/2002	A+ (neg. watch)	AAA	Aaa	AAA	EJR cut rating to A+ (neg. watch)
9/24/2002	A+	AAA	Aaa	AAA	EJR affirmed A+ rating
1/15/2003	A+	AAA	Aaa	AAA	EJR affirmed A+ rating
3/10/2003	A+	AAA	Aaa	AAA	EJR affirmed A+ rating
6/10/2003	A+	AAA	Aaa	AAA	EJR affirmed A+ rating

Freddie Mac's Senior Unsecured Ratings

Date	Egan-Jones*	S&P	Moody's	Fitch	Action
5/22/2000	AA (neg. watch)	AAA	Aaa	AAA	EJR issued neg. watch (AA)
1/30/2001	AA (neg. watch)	AAA	Aaa	AAA	EJR affirmed neg. watch (AA)
2/20/2002	A+ (neg. watch)	AAA	Aaa	AAA	EJR cut rating to A+ (neg. watch)
3/10/2003	A	AAA	Aaa	AAA	EJR cut rating to A
6/11/2003	A	AAA	Aaa	AAA	EJR affirmed A rating (dev. watch)

TESTIMONY

EFFECTIVE GSE SUPERVISION WILL LOWER THE COST OF HOME OWNERSHIP

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Before the

Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee
Financial Services Committee
U.S. House of Representatives

June 25, 2003

It is an honor to appear before you today to testify on ways to improve the safety-and-soundness supervision of Fannie Mae and Freddie Mac that enhance their mission. I am managing partner of Federal Financial Analytics, a consulting firm that offers both information and advisory services. Among the information services is one that focuses on the GSEs, and I am pleased that clients of this service include those on all sides of the debate. Our consulting service assists both private firms and governmental entities, and we have over the years advised bank regulators in the U.S. and abroad on ways to enhance their operations. We are active now in the debate over the rewrite of the Basel risk-based capital rules, and we also advise companies and associations concerned that Fannie Mae and Freddie Mac have strayed beyond their mission.

Today, I would like to outline the keys to effective bank supervision that can be quickly adopted for Fannie Mae and Freddie Mac. These standards have not impeded the ability of American banks and savings associations to promote home ownership – indeed, record home-ownership rates are due at least as much to their ability to originate mortgages as to the GSEs' ability to purchase them. In considering the pending Basel Accord, the leadership of this Committee has rightly recognized that effective U.S. bank supervision is critical not only to a secure financial market, but also to the innovation that has made the U.S. financial services industry a global leader. I see no way in which effective supervision – good as it is for insured depositories – isn't also appropriate for government-sponsored enterprises (GSEs). Indeed, I believe it will strengthen them, reduce their funding costs and, therefore, enhance their ability to promote home ownership and fulfill their Congressional mission.

Like effective bank governance, GSE supervision should be founded on the three pillars on which international bank supervisors rely: sound capital, effective supervision and market discipline. As you consider legislation to overhaul GSE regulation, these bank principles can be translated for the GSEs to ensure:

- Real minimum and risk-based capital standards that rely on real shareholder equity, not complex models that attempt to anticipate risk in untested ways. More capital would drop the cost of home ownership because the GSEs would raise funds more cheaply and they could then pass these savings on to the low-income and minority home-buyers who especially rely on them.

- Real supervision – backed by meaningful penalties – which checks and re-checks the GSEs against examiner findings, board-of-director responsibility, outside benchmarks and the experience of other large institution supervisors. OFHEO's failure to anticipate the Freddie Mac problem – indeed, its cheerleading when the restatement was first announced – cannot be repeated. As the Freddie case makes clear, supervision must ensure effective internal controls and audit standards. One must ask why the GSEs' regulator has not done what bank regulators have in recent months to address these risks, and Congress should ensure that this is done apace. The new regulator must have ample resources and the full panoply of legal powers. Like bank regulators, it must also learn in advance of new GSE ventures to be sure they do not put taxpayers or consumers at undue risk.

- Effective disclosure to ensure that policy-makers, investors and risk counterparties have all the information they need to make informed judgments that, in turn, supplement supervisory assessments and permit a real review of how well the GSEs serve affordable housing needs across the country. SEC registration is the first step, and reports analogous to those filed by banks ("call reports") would also be worthwhile.

Today, you – like the rest of Congress and the Administration – are facing an array of unpleasant choices because the regulatory structure established in 1992 for Fannie Mae and Freddie Mac is, quite simply, broken. The housing GSEs then had a total of $1 trillion in obligations; now, they have $3.2 trillion. Arguably, the 1992 scheme never could have worked because of the divide-and-conquer structure resulting from the complex compromises embodied in law. Certainly, it did not work. Although home ownership rates have continued to climb – a tribute to all participants in U.S. housing finance, not just the GSEs – GSEs have grown gigantic atop tiny regulatory capital bases, backed by an implicit taxpayer guarantee that may protect them from real market discipline.

Were there any doubt about the adequacy of GSE supervision, events in the past few weeks have dispelled them. The fact that OFHEO was clearly caught flat-footed by the Freddie Mac board decision and subsequent management dismissals on June 6 – two days after OFHEO blessed the GSE's auditing and corporate governance – is undisputed. The regulator has frequently opined – it did so just last Friday, for example – that disclosures wrought by investigative reporting or other sources looked A-OK to it, only to find as the facts came out – through others, not its examiners – that the Enterprise wasn't all that hunky-dory after all.

Bank supervisors have a long tradition of saying nothing about the condition of their charges unless or until they have to say that the bank is closed and depositors have nothing to fear. They do this to promote market discipline and avoid the inference that nothing can go wrong at a bank because bank regulators will make it all right. Bank regulators call this "constructive ambiguity," and it is imperative that the new GSE regulator maintain this posture for the housing GSEs. Without it, GSE bond and shareholders have the same bet on the table as Texas S&L shareholders in the 1980s: heads I win, tails you lose. All very large financial services firms – Fannie, Freddie, big banks and big non-banks – are too big to fail, but none should be too big to liquidate at cost to shareholders and other investors. GSE supervision should ensure that this message is understood loud and clear across the financial market.

Real Capital Means Real Risk Reduction

In the 1980s, the nation's S&Ls grew bigger and bigger atop less and less capital. As many of you will recall, the industry's regulator began this problem with "net worth certificates" – Monopoly money sanctioned by the government as a substitute for real shareholder dollars – and Congress then blessed this fiddle and several thereafter in the desperate hope that the thrift industry would right itself without a taxpayer bail-out. That didn't work, of course, and allowing GSEs to operate on capital bases that make those of the S&Ls in the 1980s look generous is a similarly dangerous bet.

Based on the hard experience of the 1980s, Congress established minimum capital standards for banks and savings associations, backing these up by the "prompt corrective action" (PCA) sanctions included in the FDIC Improvement Act of 1991. Further recognizing the importance of capital, Congress in the Gramm-Leach-Bliley Act of 1999 allowed only "well capitalized" firms to become financial holding companies and engage in the expanded products authorized by the Act. As a result, insured depositories now operate with risk-based capital of 13% and 9% leverage standards across the industry. Importantly, PCA not only encourages this high capitalization – which has been critical in recent years as the economy turned down and the dot.com bubble burst – but also includes stiff sanctions when capital falls. At the "critical" capital ratio – 2.5% under the RBC framework – regulators must close insured depositories.

In sharp contrast, Fannie and Freddie operate at bare ratios above the levels set by Congress for "adequate" capitalization. AT year-end 2002, Fannie Mae's core capital exceeded its minimum capital requirement by 3.2%, while Freddie Mac's comparable capital cushion was 10%. I shall discuss the OFHEO risk-based capital rule in a moment, but a simple RBC calculation – GSE core capital against on- and off-balance sheet assets gives Fannie a 1.5% ratio and Freddie a 1.6% one. As noted, insured depositories hold 13% in RBC. One could argue that they need to do so because of the wider risk range of their assets. However, the risk-based requirement against prudent mortgages for well-capitalized banks is 5%. Looked at this way, Fannie and Freddie still hold about 20% of the RBC required by bank regulators for high-quality mortgages, and they are well below the "critical" capital ratios at which insured depositories should be shut.

Risk-Based Capital Should Be Just That

As noted, Congress knew that simple leverage standards are a primitive way to impose regulatory capital, and it thus mandated a risk-based rule as well. As Chairman Baker knows well, it took OFHEO more than eight years finally to craft such a rule and, when it did, the results should have sent it back to the drawing board. For whatever reason, OFHEO decided to go its own way on RBC – it decided it didn't like the way the Federal Reserve, Office of the Comptroller of the Currency and – in fact – all of the regulators in the world's largest banking systems calculated risk-based capital. It set its own model-builders to work and – constrained to be sure by provisions in the 1992 Act – OFHEO brought forth a 700-plus page capital rule that, we now know, would permit the GSEs to operate at ratios of as much as 300:1 if Congress hadn't also imposed the minimum leverage standards noted above.

Under the OFHEO RBC rule, Congress has in essence double-downed its bet on GSE capital. First, it allowed them to operate at leverage ratios not otherwise permitted for regulated firms. Then, it went further by allowing OFHEO to craft its own model for capital that in turn relies entirely on GSE decisions in complex derivatives markets. In sharp contrast to the bank rules, OFHEO permits Fannie and Freddie to offset interest-rate risk and credit risk – thus eliminating regulatory capital despite the fact that these risks are highly correlated in the mortgage market.

Effective regulatory capital comparable to that required by other regulators on comparable risk will benefit home ownership, not hurt it. Fannie and Freddie were chartered by Congress to create mortgage-backed securities – off-balance sheet credit risk – not necessarily to hold the combined $1.6 trillion in portfolio assets now on their books. Importantly, this shift in their business has put Fannie Mae and Freddie Mac into the interest rate-risk game, although their charter and regulatory structure arguably are premised on the limited credit-risk one intrinsic to the securitization business. Effective capital will put the GSEs back into the arena where they best serve low-income and minority home buyers: guaranteeing risk the market might otherwise be reluctant to take.

Effective Supervision is Essential

The reason bank supervision is premised on three pillars is that none is sufficient on its own. Regulatory capital will always differ to some degree from economic capital standards dictated by the market and, in any case, they are not the sole driver of risk-taking. Although capital was the predicate cause of the collapse of the nation's S&Ls in the 1980s, several banks – Superior FSB, for example – have failed even as they complied in full with regulatory capital standards. These failures resulted in part from problems in the regulatory capital requirements then in effect and, in part, from aggressive risk-taking – or even outright fraud – at the failed banks supervisors overlooked.

Proven components of effective financial institution supervision include:

- *Independence.* Political control of bank supervision doesn't work. Policy-makers must have major input into regulatory decisions, but these should ultimately be made on the facts – sometimes highly technical ones – as seen by expert examiners. The law should dictate how regulated institutions should serve social objectives, and independent supervisors should then enforce these laws along with those mandating strict safety and soundness.

- *Recognition of All Relevant Risk.* Bank regulators review institutions in a "supervision by risk" framework that analyzes and – when necessary – acts on possible credit, interest-rate, transaction, compliance, legal, reputational strategic and other risks. Some of these non-traditional risks – reputational risk in particular – are the most serious ones, yet OFHEO now has very limited ability to address them at the GSEs.

- *Risk Anticipation, Not Reaction.* Bank regulators review new activities in advance, especially when a venture raises policy or safety-and-soundness concerns. This has not adversely affected industry innovativeness; indeed, the U.S. financial services industry leads the world in numerous areas (derivatives, asset securitization, etc.). Our market also serves consumers better than any other, which can be seen through a quick comparison of not only home ownership, but also education finance and many other forms of consumer lending. Prior review also ensures that new programs are offered in full compliance with all necessary consumer safeguards, including any additional restrictions on possible conflicts of interest, abusive lending or other problems regulators may fear. Effective advance review of new GSE programs is essential to protecting their safety and soundness and U.S. home owners, and this should thus be done by an independent agency with technical skills, buttressed by clear direction from Congress as to how the GSEs are to serve the nation's housing market.

- *Attention to Internal Controls.* As noted, bank regulators have broad risk powers which Congress has so far not provided to the GSEs' regulator. In recent months, the banking agencies have taken aggressive action in such areas as internal controls and audit standards, areas that have proven critical in financial institutions and, sadly, now also at the Freddie Mac. Clear power must be provided to the GSEs' regulator to ensure appropriate corporate governance and controls, and penalties should be readily at hand to ensure these powers are backed by enforcement as is the case at insured depositories.

Disclosure Means Discipline

Finally, I would suggest that Congress review the disclosures now made by the housing GSEs and ensure that these promote effective market discipline. If investors believe that they don't need to know much about the GSEs because the taxpayers will correct any mistakes, the risks of these giant enterprises is exacerbated. As Chairman Greenspan said on May 9, transparency is essential to a disciplined financial market especially in light of growing reliance on highly-complex financial instruments.

As with other safety-and-soundness improvements, better disclosure will enhance the GSEs' housing mission. First, it will allow Congress and the markets to see clearly the degree to which the GSEs are in fact serving the affordable-housing sector for which their benefits are aimed. It will also provide a far clearer picture of financial risks, supplementing supervisory decisions by early market intervention. Steps to improve transparency include:

- *A Real Stand-Alone Rating*. None of the "stand-alone" ratings – including that of the GSEs' subordinated debt – in fact is a real assessment of just how much risk the enterprises would run without their implicit guarantee. This should quickly be done by an objective, independent and expert agency to promote effective policy-making and investor decision-making.

- *SEC Disclosure*. Recent studies by the SEC, Treasury and OFHEO have affirmed that SEC disclosure for GSE obligations will have no adverse impact on the housing market. Reforms may be appropriate for the entire MBS market, including the GSEs, but the overall framework for the GSEs should be the same as that for all other large issuers.

- *Risk Disclosures*. Insured depositories now file quarterly "call reports" with their supervisors – which then disclose much of this data to the markets. This ensures that key risk factors unique to regulated financial services firms are available to all decision-makers, hedging the FDIC's bet as well as that of the Federal Reserve as lender of last resort. Comparable disclosures for the housing GSEs would protect taxpayers, as well as provide debt-holders and others with more information that should reduce GSE funding costs and, thus, that of home ownership.

Testimony of Thomas A. Schatz

President

Citizens Against Government Waste

Before the

House Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

June 25, 2003

Mr. Chairman, Members of the Subcommittee: I am Thomas A. Schatz, President of Citizens Against Government Waste (CAGW), an organization formed in 1984 for the purpose of identifying and eliminating waste, fraud, abuse, and mismanagement in the federal government.

We are pleased to testify today about the current status of regulatory oversight of the two housing government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. We agree that Fannie and Freddie provide a useful service to the American economy, but we believe that oversight of the GSEs much be strengthened, particularly in light of the recent developments surrounding Freddie Mac.

Prior to discussing the specific proposals being considered by the subcommittee, CAGW's eventual goal is full privatization of Fannie Mae and Freddie Mac. Recognizing this will not occur overnight, we applaud your efforts, Mr. Chairman, to take steps now to improve the oversight of the two GSEs.

There may well have been a need for federal government involvement when Fannie Mae was created in 1938, one of the worst years of the Great Depression, and perhaps there were good reasons for providing government support when Fannie and Freddie Mac were first sold to public investors.

Whatever those reasons were, they no longer apply. Fannie Mae and Freddie Mac are two of the world's largest companies; they dominate the US housing finance market. They owe their supremacy not just to their management skills, but also to their special ties to the federal government. CAGW believes those ties are inappropriate, that they should be severed, and that both GSEs should be privatized.

Therefore, despite its preference for privatization, CAGW strongly supports interim actions by the Congress that will make it clear to taxpayers and investors that Fannie Mae and Freddie Mac are no longer special entities, protected by outdated, anti-competitive ties to the federal government. It is interesting to us that it some who support government regulation of private monopolies object to stronger government oversight of the two GSEs, apparently believing that the current regulatory scheme is adequate and that the duopoly represented by Fannie Mae and Freddie Mac is benign. Moreover, Fannie Mae and Freddie Mac are rewarded, not punished, for their monopoly status by submitting to less regulation that is applied to private sector companies that are supposed to be the customers of the GSEs

Opponents of your bill, Mr. Chairman, and similar measures, also opposed prior efforts to reign in the two GSEs. CAGW believes it is incumbent upon those opposing greater oversight to explain why it is not necessary, rather than for proponents to justify their call for increased scrutiny, transparency, and accountability. In fact, it is likely that many who now voice concern over your bill were at the forefront of the Oxley-Sarbanes measure enacted last year to increase oversight of accounting practices at private sector companies. It is inconsistent to oppose similar regulation for the GSEs.

Thanks to your good work, Mr. Chairman, and to the work of this subcommittee, Congress has been examining the business of the GSEs for many years. Your subcommittee has held six hearings on the GSEs since January 1999. The Congressional Budget Office examined the Federal subsidy to Fannie and Freddie, estimating in 2000 that the subsidy was approximately $10.6 billion. Numerous government and private studies in recent years have shown that Fannie Mae and Freddie Mac lag the private market in supporting the financing of affordable housing. Your efforts have drawn support from the Federal Reserve, numerous national and local business and mainstream publications, and from groups that champion housing, good government and responsible economic policies.

Improved regulation of the GSEs has been amply examined. It is now time to act. The current bifurcated system of GSE oversight does not work, and it is exploited by Fannie Mae and Freddie Mac. Their current regulator is clearly inadequate: Freddie Mac is the fourth largest financial services company in the United States, yet its safety and soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO) seems to have been unaware of any problems with the company's accounting procedures.

Less than a week before the recent management shakeup, OFHEO gave Freddie Mac a clean bill of health, stating that no big surprises from the earnings restatement could be expected. Clearly, OFHEO was wrong. And we still do not know the full scope of the problems at Freddie Mac, and recent press reports indicate that Fannie Mae may not be completely free of concern, either.

We cannot even defend the GSEs on the grounds that they adequately promote affordable housing, which is their core mission. The Department of Housing and Urban Development (HUD), which is responsible for regulating that mission, has allowed the GSEs to lag the private market for years. Numerous public and private studies have documented that failure. Instead, the GSEs eagerly expand into new areas of financing and investment, getting closer and closer to direct consumer lending, and HUD, which is supposed to approve new GSE programs, does nothing to check their growth.

Congress does not need to conduct further investigation. It should enact legislation this year that will bring greater accountability and transparency to the GSEs, while reducing the risk to taxpayers. These are some of the many changes which should be made along the road to complete privatization:

1. Strengthen safety and soundness regulation by moving this responsibility to the Department of the Treasury;
2. Provide the new regulator with powers comparable to those available to bank regulators;
3. Require that the GSEs hold bank-like capital;
4. Fund the regulator through assessments on the GSEs, comparable to fees imposed to fund bank regulators;

5. Require that all new programs initiated by the GSEs receive approval from its mission-directed regulator only after collecting public comments on the proposed new program;
6. Permit new programs only if the program does not violate the GSEs' charters, will not undermine the safety and soundness of the GSEs, is in keeping with the GSEs' mission to promote affordable housing, and does not involve direct consumer lending of any kind;
7. Apply Community Reinvestment Act standards to the GSEs;
8. Tighten the national affordable housing standard that now applies to the GSEs by making those standards apply within individual metropolitan statistical areas;
9. Repeal Fannie Mae's and Freddie Mac's exemption from the Securities Act of 1933 and the Securities Exchange Act of 1934;
10. Repeal the GSEs' exemption from the privacy provisions which, under Gramm-Leach-Bliley, apply to all other financial institutions;
11. Cap the amount of their own and each other's MBS which the GSEs may hold in their own portfolios;
12. Cap the amount of debt the GSEs may issue without seeking Treasury approval;
13. Repeal the GSEs' exemption from state and local taxes;
14. Repeal the $2.25 billion line of credit to the US Treasury which exists for each GSE;
15. Limit bank investments in GSE securities.

We recognize that this list is ambitious, yet you have included many of these concepts in your new bill, Mr. Chairman. We applaud your commitment to strengthening the regulation of the GSEs, but we believe additional provisions are necessary to provide true protection for American taxpayers, homebuyers and investors. We recommend that three provisions in particular are essential now: a requirement for bank-like capital for Fannie Mae and Freddie Mac; consolidation of safety and soundness and new program authority in a single strong regulator; and repeal of the GSEs' exemption from Federal securities laws.

REQUIRE BANK-LIKE CAPITAL

Despite the many years it took OFHEO to develop its risk-based capital rule and the economic model upon which it is based, we have little confidence that the rule or the model are meaningful checks on the GSEs' high-flying financials. We strongly support your bill's establishment of prompt corrective action powers for the new regulator.

However, CAGW recommends that your bill go farther. Fannie Mae and Freddie Mac should be subject to the same capital standards as banks, including compliance with the Basel Capital Accords now undergoing revision.

This view is supported by the Federal Reserve. In his April 21, 2003 letter to you, Federal Reserve Chairman Alan Greenspan stated the importance of increased capital for the GSEs:

> ...the existence, or even the perception, of government financial support for financial institutions undermines the effectiveness of market discipline. Thus, in the case of the housing-related GSEs – Fannie Mae, Freddie Mac, and the Federal Home Loan Banks – to ensure that these institutions do not pose a systemic threat regulators cannot rely wholly on market discipline and must assess whether these institutions hold appropriate amounts of capital relative to the risks they assume and the costs they might impose on others, including taxpayers.

In March of this year, William Poole, President of the Federal Reserve Bank of St. Louis, spoke on the importance of this issue, recommending that "over a transitional period of several years, the GSEs should add to the amount of capital they hold." Mr. Poole continued,

> Capital is especially important for the GSEs because their short-term obligations are large. Fannie Mae and Freddie Mac have debt obligations due within one year of about 45 percent of their debt liabilities. Any problem in the capital markets affecting these firms could become very large, very quickly. What might 'very quickly' mean? Because of the scale of the short-term obligations of the GSEs, the GSEs are rolling over many billions of dollars of obligations each week. For this reason, a market crisis could become acute in a matter of days, or even hours.

I ask, Mr. Chairman, that the entire text of Mr. Poole's speech be included in the hearing record, attached hereto as Exhibit A, but I would like to draw your attention to one other quote in his speech:

> The core capital requirement [for the GSEs] is 2.5 percent of on-balance sheet assets and 0.45 percent of outstanding mortgage-backed securities and other off-balance sheet obligations. ...In the private sector, government securities dealers carry capital in the neighborhood of 5 percent, and other financial firms considerably more. For example, FDIC-insured commercial banks hold equity capital and subordinated debt of a bit under 11 percent of total assets.

The risks posed by Fannie Mae and Freddie Mac are more dangerous than those posed by the Federal Home Loan Banks because Fannie Mae and Freddie Mac are so large, so thinly capitalized, and so dominant in their field. Following the lead given by Chairman Greenspan and Mr. Poole, we endorse the imposition of bank-like capital as key to the success of any new regulatory regime.

Without the imposition of stricter capital standards, the GSEs will always pose the problem of systemic risk. While a recent OFHEO report on systemic risk took comfort in the GSEs' risk management, we disagree. Fannie Mae and Freddie Mac are huge and they are getting bigger. CAGW is deeply concerned about the significant potential for serious problems in our economy if either of the GSEs gets into trouble. Yet their zeal for growth is insatiable, and we believe, irresponsible.

In early 2000, when it appeared that the federal government was going to run surpluses for the first decade of the twenty-first century, Speaker Hastert and then-President Clinton made public commitments to eliminate the $3.6 trillion public debt entirely by 2015. In fact, the Department of the Treasury went so far as to announce that it would no longer issue 30-year bonds, and Wall Street began to discuss what would be the best new benchmark for the private debt markets.

Because of their special status as government-sponsored enterprises, as well as their allegedly impeccable accounting and financial controls, Fannie Mae and Freddie Mac quickly offered themselves, even though they had $2 trillion in outstanding debt and MBS, nearly as much as the privately held national debt at that time, which was $2.7 trillion. One more statistic: in 1999, as we paid down $140 billion in national debt, the GSEs simultaneously increased their debt by $309 billion. Thus, the GSEs were on a trajectory that had them issuing so much debt and MBS, that by mid-2001, Fannie Mae and Freddie Mac would have had more debt and MBS outstanding than the Federal government.

This conceit by Fannie and Freddie was entirely misplaced and inappropriate. While there are few benefits of the $350 billion budget deficit, preventing Fannie Mae and Freddie Mac from becoming the nation's benchmark for interest rates is the best result of an otherwise poor economic circumstance. The present situation at Freddie Mac should eliminate any possibility of a GSE benchmark for many years to come.

STRENGTHEN THE NEW REGULATOR

CAGW supports your plan to move the GSEs' regulator from HUD to Treasury and its independence from the appropriations process by the assessment of fees on Fannie Mae and Freddie Mac.

However, we believe that new program approval should come under the jurisdiction of the new regulator, as well as safety and soundness. Most of the new programs that the GSEs propose are new financial products. At present, HUD has no more than seven people overseeing Fannie Mae and Freddie Mac. While they may be equipped to opine about the impact on homebuyers of a proposed new product, these people have little expertise to assess how that product will affect a GSE's safety and soundness. Any GSE regulator must have sophisticated financial markets expertise, not simply an understanding of how to reach out to potential homebuyers about the best way to shop for a mortgage.

The possibility of systemic risk posed by the GSEs is inextricably tied to the scope of their activities. Every outreach into broader and more innovative financial products holds the potential of undermining the safety and soundness of the GSEs. Despite the enactment of the 1992 Federal Housing Enterprises Financial Safety and Soundness Act, which directed HUD to establish a meaningful pre-clearance program, the GSEs have moved closer and closer to direct consumer lending through a series of so-called "pilot" programs that are offered throughout the United States. In many of these programs, the GSEs choose to partner with individual lender or other primary mortgage market participants, thereby creating winners and losers through their market dominance.

CAGW urges you to use this opportunity to bring greater accountability and transparency to the GSEs' while reducing taxpayer risk. Not only do we believe that Fannie Mae and Freddie Mac are too big, we believe that, left unchecked, they will dominate all consumer lending. It is the responsibility of the federal government to exercise responsible oversight before their growth leads to the federalization of the nation's mortgage and consumer finance industry.

REPEAL THE EXEMPTION FROM THE SECURITIES LAWS

Finally, your bill should include provisions comparable to H.R. 2022, legislation introduced by Representatives Christopher Shays and Edward Markey, to repeal the exemption from the securities laws that apply to every other publicly traded company that meets SEC standards for registration.

Last July, under pressure from Congress and federal regulators, Freddie Mac and Fannie Mae agreed to register with the SEC and adhere to the agency's financial reporting rules. While this promise was an important concession, the GSEs continue to be exempt from full compliance with the Securities Act of 1933, which requires publicly traded companies to register their equity, MBS and debt. Moreover, they remain exempt even from key provisions of the Securities Exchange Act of 1934, such as the rules governing tender offers, proxies, and public reporting of trades by large shareholders and insiders. And, while Fannie Mae followed through on its commitment to register, Freddie Mac has not. Because its promise to register with the SEC was not required, Freddie Mac has violated no law.

This month's news regarding Freddie Mac clearly demonstrates the implications of exempting the GSEs from the federal securities laws. It also illustrates why voluntary disclosure is meaningless. Any other company which is forced to restate earnings must continue to file its financial statements with the SEC; failure to do so subjects the company to SEC sanctions. In such cases, the message to investors is clear that the company has not complied with the law. In Freddie Mac's case, the failure to register seems not to matter. The SEC did not initiate an investigation of Freddie Mac until after the announcement of its management shakeup.

We endorse the view of the Treasury Department, OFHEO, and the SEC in their February 2003 study of MBS disclosure, which made the following observation:

> "The Task Force finds more persuasive the arguments of other investors and market participants who counter that any adverse effects from additional disclosure would be short-term, and ultimately would be outweighed by the benefits of greater information flowing into, and therefore more informed analysis of, the MBS market."

Just last month, the Congressional Budget Office supported this view in a report that determined that requiring Fannie Mae and Freddie Mac to register their debt securities with the SEC would not disrupt the mortgage market or prevent homebuyers from locking in interest rates, as the GSEs have claimed. And Moody's Investor Service last week stated that making all GSE securities subject to SEC registration would be "a good thing."

Congress has long acknowledged the need of investors and others for a standardized system of continuous disclosure of material information. There is no policy reason for Fannie Mae and Freddie Mac to remain exempt from that system any longer. These financial giants should be held to the "gold standard" of disclosure, as former SEC Chairman William McDonough has said, and as endorsed by Chairman Greenspan.

CONCLUSION

We commend this subcommittee for its continuing investigation into how best to manage the GSEs. However, recent events mean that the time for inquiry is ended it is time for action. We urge the members of the subcommittee to enact legislation that will establish a strong regulator, with the authority to impose bank-like capital standards, and to repeal the GSEs' exemption from the securities laws. We also support additional oversight and transparency, as well as eventual privatization, once these interim steps are taken.

It is clear that because of their huge size and market concentration, Fannie Mae and Freddie Mac are too big to fail. In its statement last week that increased government oversight would not hurt the housing finance market, Moody's made this very point.

Finally, Mr. Chairman, no matter how many times the GSEs say that they are private companies, independent of the government, everyone knows that it not the case. The American taxpayer is on the hook if anything goes wrong with the GSEs, and therefore, effective regulation and accountability must be of paramount importance.

Exhibit A

Housing in the Macroeconomy

William Poole*
President, Federal Reserve Bank of St. Louis

Office of Federal Housing Enterprise Oversight Symposium
Ronald Reagan Building and International Trade Center
Washington, DC
March 10, 2003

*I appreciate assistance and comments provided by my colleagues at the Federal Reserve Bank of St. Louis. Robert H. Rasche, Senior Vice President and Research Director, and William R. Emmons, Economist, were especially helpful. I take full responsibility for errors. The views expressed are mine and do not necessarily reflect official positions of the Federal Reserve System.

Housing in the Macroeconomy

I am very pleased to be here this morning to participate in this symposium sponsored by the Office of Federal Housing Enterprise Oversight. The topics are important, and the list of speakers impressive.

My purpose is to provide an overview of longer-run trends in housing and housing finance to provide a setting for the papers presented later today. The United States is well housed, and the housing finance system has been working efficiently in recent years. In the first two sections of my remarks, I'll discuss some of the history and report some measures showing how the housing stock has changed over time, and how the housing finance system has developed. Our aim must be to sustain and extend this progress.

The third section of my remarks reflects my long-standing interest in issues of financial stability stemming from my study of monetary economics and financial history. Given the enormous importance of housing and housing finance to the U.S. economy, I think we do need to carefully examine the potential for financial instability, and consider steps that could reduce the risk. In this context, I especially want to commend OFHEO for its recent report entitled, "Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO." This report displays an impressive depth of scholarship in reviewing a large body of professional literature on the subject. It deserves careful study by every economist interested in issues of financial stability and every policymaker with an interest in housing and housing finance.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis—especially Robert H. Rasche, Senior Vice President and Director of Research and William R. Emmons, Economist—for their assistance and comments, but I retain full responsibility for errors.

Some Facts about Housing

Housing, particularly owner-occupied housing, has long been a public policy issue in the United States. Over the years, these discussions developed in two different directions: one focusing on the availability of housing for lower-income families, which I will not address here, and the other on the development of housing in general and the efficiency of mortgage markets.

The discussion of policies toward housing and mortgage markets dates back to at least 1918.(1) During the Great Depression, the National Housing Act of 1934 created the Federal Housing Administration (FHA) with the mandate to insure private residential mortgages. In the aftermath of World War II, the Serviceman's Readjustment Act of 1944 created the Veterans Administration (VA) home-loan guarantee program.(2) Mortgages insured (or guaranteed) by the government gained considerable market share throughout the 1940s and 1950s, reaching a peak share of 44.3 percent of 1-4 family home mortgages in 1956. Since then, the share of government-insured mortgages has declined steadily; by the end of 2000 the share amounted to only 13.8 percent.(3)

The original Federal National Mortgage Association—Fannie Mae, as it came to be unofficially and affectionately called—was organized in February 1938 to increase the volume of residential construction and develop a secondary market in government-insured or guaranteed mortgages.(4) To achieve the first objective, from its inception Fannie Mae purchased mortgages and issued its own debt. Initially, Fannie Mae was funded through the sale of preferred stock to the Treasury. According to Jack M. Guttentag, writing in 1963, government support was regarded as transitory since it was "hoped that eventually the Treasury's investment can be retired with the proceeds of common stock along with retained earnings, and the function transferred to private ownership."(5) This objective was partially achieved in 1968 when the original Federal National Mortgage Association was split into two parts: Government National Mortgage Association, or Ginnie Mae, which remained a government agency, and a successor Fannie Mae (officially, still the Federal National Mortgage Association) that was spun off as a private corporation under a federal government charter. In 1970 Ginnie Mae started guaranteeing mortgage-backed pass-through securities representing shares in pools of FHA/VA guaranteed loans.(6) At the same time, the Federal Home Loan Mortgage Corporation—Freddie Mac—was created to promote the development of a secondary market in conventional mortgages.

Another important development in the 1930s was the creation in 1932 of the Federal Home Loan Bank System (FHLB), which was chartered to provide liquidity to thrift institutions. In 1934 the Federal Savings and Loan Insurance Corporation (FSLIC) was established to provide insurance on shares of depositors in thrift institutions.(7)

With these institutions in place, though not necessarily because of their creation, the net stock of real residential assets per capita began to grow after World War II.(8) The stock had been trendless between $12,500 and $13,000 1996 dollars from the mid 1920s until after World War II. From 1948 to 1970 the net real per capita stock of residential structures grew at a 1.9 percent annual rate. From 1971 to 2001 the net stock grew at a somewhat lower average annual rate of 1.5 percent. By the end of 2001, the net per capita stock of real residential structures had grown to $32,700 1996 dollars.

As the stock of residential structures was growing, the quality of the housing stock was improving. According to the 1950 Census, 35.5 percent of houses lacked complete plumbing facilities. By 2000 the fraction of houses without complete plumbing had fallen to 0.6 percent. In the 1960 Census—the first census that included a question on telephones—21.5 percent of houses had no telephone. By 2000 only 2.4 percent of houses lacked a telephone. In the 1970 Census 4.4 percent of houses was recorded as lacking complete kitchen facilities. By 2000, only 1.3 percent of houses was recorded as without complete kitchen facilities. During this period the median size of houses also increased—from 4.6 rooms in 1950 to 5.3 rooms in 2000.(9)

As the quantity and quality of the residential housing stock increased, homeownership also became more widespread. In the 1950 Census the homeownership rate was reported at 55 percent—by the 2000 Census it had increased to 67.5 percent.

Some Facts about Housing Finance

Growth of the housing stock could not have occurred without a robust system of mortgage finance. There are several distinct sources of mortgage finance in the United States.(10) The importance of these sources has varied considerably over the years since World War II. The share of 1-4 family mortgage loans held by commercial banks increased in the immediate aftermath of World War II to a peak of 19.4 percent in 1948; it then trended down to 13.4 percent in 1961 at which point the trend reversed and the share trended up again, reaching almost 24 percent in 2000. Life insurance companies were a significant player in the residential mortgage market immediately after World War II, but their share of lending peaked in 1951 at 23.5 percent and has trended down ever since. By 2000, the share of life insurance companies was only 3.4 percent, so these institutions have ceased to be a significant factor in the residential mortgage market. The share of "all other," which includes lending by individuals and private mortgage pools decreased from 34.1 percent at the end of World War II to 12.3 percent in 1977, after which it started trending up and reached 21.4 percent by 2000.

The two remaining types of institutions that at different times have been the most significant players in the residential mortgage lending market are savings institutions (including savings and loan associations and mutual savings banks) and U.S. agencies including Ginnie Mae, Fannie Mae, Freddie Mac, and mortgage pass-through securities guaranteed by federal agencies or government sponsored enterprises (GSEs). The share of savings institutions in residential mortgage lending grew rapidly after World War II, reaching 46 percent in 1965. These institutions maintained their market share until 1978, but then lost share dramatically.

The decline of the savings institutions was a consequence of rising nominal interest rates combined with duration mismatch, which together generated the Savings and Loan crisis of the 1980s. By 1990, when the S&L crisis was finally resolved, the share in the residential mortgage market of these institutions had shrunk to 21.1 percent, less than half of the peak market share twenty-five years earlier. In the subsequent decade the market share held by these institutions shrunk by half again, to only 10.4 percent at the end of 2000.

As the presence of savings institutions in the residential mortgage market receded, the financing void was filled by U.S. government agencies. In 1967, immediately before the Housing Act of 1968 and reorganization of the established Fannie Mae into Ginnie Mae and the new Fannie Mae, the share of the residential housing mortgage market for government agencies was 5.5 percent. By 1990, these institutions captured a third of the residential mortgage market, either through mortgages purchased for their own portfolios or through guaranteed mortgage-backed securities. Recent data indicate that their market share is 42.5 percent as of the end of the third quarter of 2002. Clearly, the efficiency and stability of the government agencies has become a critical factor in the financing of residential construction.

Financial Stability

Residential mortgage debt has grown enormously as a fraction total nonfinancial debt in the United States. Starting at slightly more than 5 percent at the end of World War II, the share grew steadily until it exceeded 20 percent in the early 1960s. From then until the mid 1980s, the share fluctuated in the neighborhood of 20 percent or a bit more. In the past 15 years the share again grew steadily until it reached 30 percent at the end of 2001.(11) Given the current magnitude of mortgage debt outstanding relative to total credit market debt, any serious instability in the financing of the residential capital stock has the potential for significant effects not only on the housing industry and house prices but also on the entire economy.

The annual reports of Fannie Mae and Freddie Mac, and the recent OFHEO report on Systemic Risk, provide much useful information on risk management. It is insightful to divide this subject into two parts. One concerns management of credit, interest-rate and operational risks that can be modeled with the assistance of financial theory and evidence from the behavior of financial markets. Risks that can be studied and modeled can be termed "quantifiable risks." Nonquantifiable risks deserve separate attention.

There are certainly cases in which firms, and sometimes regulators, make mistakes in dealing with quantifiable risks. Over the years, many financial institutions have failed because of such mistakes. Savings and loan association failures, which ultimately led to the failure of the Federal Savings and Loan Insurance Corporation (FSLIC), were mostly of this type. Starting in the late 1960s, economists warned for years that the extreme maturity mismatch from S&L balance sheets with long-term, fixed-rate mortgages financed through short-term liabilities put the industry at great risk. As those risks were realized, many firms failed and the S&L industry declined to a shadow of its former self. The cost to taxpayers to make good on the insurance guarantee offered by FSLIC was in the neighborhood of $150 billion. As a consequence of this experience, managers of firms, regulators and those active in financial markets are today well aware of the need for careful risk management.

The OFHEO report makes an extremely important point about nonquantifiable risks:

A further obstacle to quantifying systemic risk is the inherent difficulty in using quantitative techniques to analyze catastrophic events such as wars and financial crises. Such events are rare, often involve significant departures from recent historical experience and can develop from a potentially infinite set of conditions. Analysts generally do not model, simulate, or predict the course and consequences of unconditional financial crises, making it difficult to obtain a precise estimate of the likelihood of a specific level of economic losses resulting from potential financial crises. As a result, government officials who seek to plan for such events cannot rely on the usual quantitative techniques to evaluate alternative strategies for addressing them. (p. 87)

In a previous speech I suggested that periods of great market instability arise when three conditions are met. First, something happens that has widespread significance—is large enough to matter to lots of people. Second, the triggering event is a surprise. Ordinarily, events long anticipated are not troublesome because corrective action occurs before problems arise. Third, substantial uncertainty clouds resolution of the problem. It is especially difficult for investors to know what to do when the government's response to an unfolding situation is highly uncertain.(12)

Given the extensive discussion of quantifiable risks, I want to concentrate on the nonquantifiable risks. It helps to make this issue concrete by listing some examples. The failure or near failure of Penn-Central, Continental-Illinois, Long-Term Capital Management, Enron and WorldCom may not have been complete surprises to knowledgeable insiders, but the shocks were certainly "news" to market participants, regulators and the general public. No one predicted the timing of the stock market crash of 1987, or the peak of the equity markets in the spring of 2000. It is well known that even the great Yale economist Irving Fisher was caught completely off guard by the crash of 1929. Surprise legal decisions brought bankruptcy to 52 firms involved with asbestos, to Dow-Corning and to Texaco. Finally, while experts in terrorism may have understood the risks of attacks on U.S. soil, their information was not sufficient to prevent the September 11 attacks; certainly no one else had any basis for predicting the attacks. All of these cases, with the possible exception of Continental-Illinois, reflected nonquantifiable risks.

The point here is not to fault the forecasting record of any person or any agency. Rather, it is to illustrate that major unforeseen events that can bring about a collapse in confidence or disruption to the normal function of financial markets without any warning can and do occur with some frequency. The history of the United States, as well as other countries, is replete with such examples.

A little discussed but critically important dimension of systemic risk is the uncertainty about how the government and regulators will respond to a major unforeseen event.(13) Before the 1987 stock market crash there was considerable overconfidence that a break in equity prices such as occurred in 1929 was not possible given modern institutions. As a result, in the initial hours of the 1987 crash, the public did not know exactly how the Fed would react to a systemic liquidity crisis. The way the Fed handled that situation is, in my judgment, one of the high-water marks in the history of our central bank. Not only was a generalized liquidity crisis averted, but also considerable institutional credibility was created. The repercussions in financial markets on 9/11 might have been much worse had the Fed not demonstrated in 1987 that it could and would react immediately to major market disruptions.

There are historical cases where the reactions by government agencies and regulators to unpredicted crises, in my judgment, did not result in such institution building. A good example is the market perception that public policy has established a "too-big-to-fail" doctrine. This perception grew over time, and became more entrenched as a result of the Continental-Illinois situation. The net result is that market participants expect that, under ill-defined conditions, regulators and/or government agencies will in fact insure statutorily uninsured positions involving large financial institutions. Is the doctrine really "too big to fail" or "too big to liquidate quickly?" How big does a financial institution have to be, and does it have to be a depository institution, to be "too big to fail?" In this respect, there is tremendous ambiguity about the status of the GSEs. The market prices the GSEs' debt as if there were a federal guarantee, or a high probability of a guarantee, standing behind their entire outstanding obligations. Yet, there is no explicit guarantee in the law. Actual experience has left the markets with all of these important questions and ambiguities.

No one should underestimate the potential importance of the ambiguity over the financial status of the GSEs. Would "too big to fail" be extended to GSEs in a crisis, and if so how would it be effected in the absence of a federal insurance agency with an unlimited line of credit? How quickly could such a rescue be implemented?

It is not sufficient for any single GSE to argue that its own financial condition is sound. If one GSE comes under a cloud, others may also. That has been our experience with financial firms again and again. It is the process economists call "contagion" whereby uninvolved or innocent firms are affected because the market has difficulty distinguishing solid firms from those at risk.

In the case of the GSEs, the enormous scale of their liabilities could create a massive problem in the credit markets. If the market value of GSE debt were to fall sharply, because of ambiguity about the financial soundness of GSEs and about the willingness of the federal government to backstop the debt, what would happen? I do not know, and neither does anyone else.

Let me throw out for debate two steps the federal government might take to resolve the ambiguity that I see as a fundamental risk to the continuing stability of our financial system. First, various aspects of federal sponsorship that the market reads as providing an implied guarantee of GSE debt should be withdrawn.(14) The Secretary of the Treasury has the authority to buy GSE obligations; in the case of Fannie Mae and Freddie Mac, the authority is up to a maximum of $2.25 billion for each firm. The GSEs could easily replace this potential source of emergency financial support with credit lines at commercial banks, following the widespread practice among issuers of commercial paper. In any event, the amount available at the discretion of the Secretary of the Treasury is far too small to deal with a crisis in the GSE debt market. Eliminating the Treasury's authority to lend to the GSEs would provide a signal that the government is serious when it says that there is no government guarantee of GSE debt.

Second, over a transitional period of several years, the GSEs should add to the amount of capital they hold. Capital is critical because when there is a crisis in the securities markets, financially strong firms can stand the pressure without lasting damage. Capital provides a cushion against mistakes and unforeseeable circumstances. With adequate capital, a firm can almost always raise emergency loans to cover its liquidity problems. The importance of adequate capital became clear to policymakers as the S&L problems accumulated in the late 1980s. Tightening capital standards for insured depository institutions and strengthening the administration of those requirements were key components of the reforms put in place at that time.

Capital is especially important for the GSEs because their short-term obligations are large. Fannie Mae and Freddie Mac have debt obligations due within one year of about 45 percent of their debt liabilities. Any problem in the capital markets affecting these firms could become very large, very quickly. What might "very quickly" mean? Because of the scale of the short-term obligations of the GSEs, the GSEs are rolling over many billions of dollars of obligations each week. For this reason, a market crisis could become acute in a matter of days, or even hours.

Capital on the books of Fannie Mae and Freddie Mac is well below the levels required of regulated depository institutions. Let me quote a paragraph from the 2001 Annual Report of Fannie Mae, the largest single GSE. During 2001, Fannie Mae issued $5 billion of subordinated debt that received a rating of AA from Standard & Poor's and Aa2 from Moody's Investors Service.

Fannie Mae's subordinated debt serves as a supplement to Fannie Mae's equity capital, although it is not a component of core capital. It provides a risk-absorbing layer to supplement core capital for the benefit of senior debt holders and serves as a consistent and early market signal of credit risk for investors. By the end of 2003, Fannie Mae intends to issue sufficient subordinated debt to bring the sum of total capital and outstanding subordinated debt to at least 4 percent of on-balance sheet assets, after providing adequate capital to support off-balance sheet MBS. Total capital and outstanding subordinated debt represented 3.4 percent of on-balance sheet assets at December 31, 2001. (pp. 44-5)

The capital situation at Freddie Mac is about the same as the one at Fannie Mae. The capital adequacy standards applying to these two GSEs were established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. The core capital requirement is 2.5 percent of on-balance sheet assets and 0.45 percent of outstanding mortgage-backed securities and other off-balance sheet obligations. The off-balance sheet obligations have a capital requirement because they are guaranteed by Fannie and Freddie.

In the private sector, government securities dealers carry capital in the neighborhood of 5 percent, and other financial firms considerably more. For example, FDIC-insured commercial banks hold equity capital and subordinated debt of a bit under 11 percent of total assets.

The issue with Fannie Mae and Freddie Mac is not primarily one of disclosure. Their annual reports disclose quite well the high degree of complexity of their operations, and the small amount of capital they carry above what is required by law. My questions are these: Given the complexity of their operations, is the capital standard in the law adequate? Why is the standard so far below that required of federally regulated banks? What will happen to the housing market if Fannie and Freddie become unstable?

Reports issued by Fannie Mae and Freddie Mac, and the recent OFHEO report on Systemic Risk, indicate that the two firms employ state-of-the-art risk management. Nevertheless, my sense is that the firms are vulnerable to nonquantifiable risks, because their capital positions are so low.

In my judgment, the only way for financial institutions to insure stability in the event of nonquantifiable shocks is for them to maintain a substantial extra capital cushion above that deemed necessary by analysis of quantifiable risks. One way of thinking about the appropriate size of that cushion might be to decide that a firm should be able to meet its maturing obligations without borrowing for a certain period of time. The length of the period would depend on an assessment of how long it would take to resolve whatever problem might arise. Under this criterion, the capital cushion would have to be invested in highly liquid, short-term assets not subject to depreciation due to interest rate changes or credit risks, so that maturing obligations could be met for a time without resort to issuing new obligations.

Dismissing the risks of nonquantifiable events on the grounds that they are too improbable to worry about is not a wise approach to public policy. For one thing, these events are not so rare as they might seem. For another, the costs of a rare event that has major consequences to the economy can easily outweigh a long stream of benefits that are orders of magnitude smaller.

Summing Up

The United States has enjoyed many years of a rising stock of residential capital. Moreover, dwellings have increased in average size and quality. The nation's housing finance system has been effective in making this growth possible.

The housing finance system historically has been highly diversified. As a group, the share of savings institutions in residential mortgage lending reached 46 percent in 1965, but hundreds of institutions were involved. The diversification of lending by different types of institutions and numerous firms within a class of institutions has been an important element of stability, because the failure of one or even many firms has not shaken the system. Competing firms have been able to enter the market to fill any voids left by failing firms.

Today, the housing finance system is heavily concentrated. Just three firms—Fannie Mae, Freddie Mac and Ginnie Mae—account for over 40 percent of the residential mortgage market. Ginnie Mae is backed by the full faith and credit of the U.S. Government Fannie Mae and Freddie Mac are not so backed, and hold capital far below that required of regulated banking institutions. Should either firm be rocked by a mistake or by an unforecastable shock, in the absence of robust contingency arrangements the result could be a crisis in U.S. financial markets that would inflict considerable damage

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Footnotes

1. Harry S. Schwartz, "The Role of Government Sponsored Intermediaries," *Housing and Monetary Policy*, Federal Reserve Bank of Boston, Conference Series 4, 1970, p. 68.
2. George F. Break, "Federal Loan Insurance for Housing," Commission on Money and Credit, *Federal Credit Agencies*, Commission on Money and Credit, Englewood Cliffs, NJ: Prentice-Hall, Inc. 1963, p. 2.
3. Source: 1939-59: *Economic Report of the President*, February 1970, Table C-58; 1960-2000: *Economic Report of the President*, February 2002, Table B-75.
4. Jack M. Guttentag, "The Federal National Mortgage Association," *Housing and Monetary Policy, Federal Credit Agencies*, Commission on Money and Credit, Englewood Cliffs, NJ: Prentice-Hall, Inc. 1963, p. 69.
5. Jack M. Guttentag, "The Federal National Mortgage Association," *Housing and Monetary Policy, Federal Credit Agencies*, Commission on Money and Credit, Englewood Cliffs, NJ: Prentice-Hall, Inc. 1963, p. 73.
6. P.H. Hendershott, "The Market for Home Mortgage Credit", in R.A. Gilbert (ed.) *The Changing Market in Financial Services*, proceedings of the 15th Annual Economic Policy Conference of the Federal Reserve Bank of St. Louis, Norwell MA: Kluwer Academic Publishers, 1992, p. 100.
7. Ernest Bloch, "The Federal Home Loan Bank System," Commission on Money and Credit, *Federal Credit Agencies*, Commission on Money and Credit, Englewood Cliffs, NJ: Prentice-Hall, Inc. 1963, p. 168-72.
8. Bureau of Economic Analysis, U.S. Department of Commerce, Chain-Type Quantity Indexes for Net Stock of Fixed Assets and Consumer Durable Goods. End-of-year quantity indexes are available from 1925-2001. The quantity indexes of net stocks of real residential and nonresidential assets are converted into net stocks valued in 1996 dollars.
9. Rooms exclude bathrooms.
10. Source: 1939-59: *Economic Report of the President*, February 1970, Table C-59; 1960 to 2000: *Economic Report of the President*, February 2002, Table B-76.
11. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*, Table L.2, Credit Market Debt owed by Nonfinancial Sectors.
12. "Financial Stability" presented before The Council of State Governments Southern Legislative Conference Annual Meeting, New Orleans, Louisiana, Aug. 4, 2002
13. I discussed this issue at some length in "Expectations," Federal Reserve Bank of St. Louis, *Review*, March/April 2001 Vol. 83, No. 2.
14. Farmer Mac, another GSE, was much in the news in the recent past. An article in *The New York Times* noted that one of the advantages conferred by government sponsorship is "the ability to borrow almost as cheaply as the government does because of a perception of government backing that emanates from a single section in its charter. That provision allows the Treasury,in certain circumstances, to provide up to $1.5 billion in loans to Farmer Mac to support the guarantees the company extends on farm loans" (June 9, 2002, page 8, column 1).

Left Out of Bill, Old Vision for Radical Reform

From: American Banker

Wednesday, June 25, 2003
By Rob Garver

Many expected that Rep. **Richard** H. **Baker** would sense blood in the water and use the crisis at Freddie Mac to push through a major legislative initiative to rein in the mortgage giant and its sibling, Fannie Mae.

Instead the Louisiana Republican has come out with a relatively measured proposal that would overhaul the regulatory agencies responsible for supervising Fannie and Freddie while leaving the government-sponsored enterprises' structure largely untouched.

Discussing the bill he was expected to introduce Tuesday, Rep. Baker said: "It is focused. It is narrowly crafted. It is not the Baker legislation of old."

"We do not amend the charter, we do not remove the lines of credit," he said. "What we do, however, is provide the new regulator with all the same financial regulatory authorities that any other financial regulator in America has."

The GSEs' safety and soundness regulator, the Office of Federal Housing Enterprise Oversight, would be abolished under Rep. Baker's Bill. A new entity, the Office of Housing Finance Supervision, would be created and melded with the Office of Thrift Supervision.

The new entity would be funded through an assessment on the enterprises -- a step OFHEO Director Armando Falcon Jr. has been advocating for years as preferable to his agency's reliance on the politically fraught congressional appropriations process.

The bill also would give the Department of Housing and Urban Development more power to police Fannie and Freddie's adherence to their mission. It would do this by requiring that the agency approve all new products before the companies could market them and by funding HUD's oversight of Fannie and Freddie through assessments as well.

In the past Rep. Baker has played the role of legislative bomb-thrower, once proposing to abolish OFHEO and put Fannie and Freddie under the Federal Reserve Board's supervision -- a suggestion made with no apparent support from the Fed or from his fellow legislators.

But now, with the accounting troubles at Freddie Mac providing him with more political cover than he has had in the past, Rep. Baker has been able to focus less on persuading people that there is a problem and more on proposing ways to fix it.

Rep. Baker officially unveiled his plan Tuesday morning in an outdoor press conference on Capitol Hill. He repeatedly referred to his bill as a starting point in the discussion of improved GSE regulation, insisting he was willing to discuss any practical solution.

"My aim is an independent, well-funded regulator with bank-like enforcement authority," he said.

He said that he had selected the thrift agency as OFHEO's partner because the OTS "has experience with the examination of institutions that are in the mortgage portfolio business, so it is a logical place for us to begin."

Mr. Baker noted that he left a number of controversial provisions out of the bill in hopes of smoothing its passage. Among them, he said, were shifting supervision of the 12 Federal Home Loan banks to the new housing agency, the Office of Housing Finance Supervision. Still, he said he would like to see supervision of the Home Loan banks reside at the OHFS as well eventually.

Restrained though his remarks were, Rep. Baker could not resist jabs at OFHEO.

Rep. Baker, the chairman of the House Financial Services capital markets panel, predicted there will be a vote in his subcommittee by late July. "I would love to have House action on this bill in the early fall," he said.